IN THE

Supreme Court of the United States

No. 76-41

FIRST NATIONAL BANK OF HOLLYWOOD, DOROTHY BUCHMAN and SANDER BUCHMAN, as Executors of SAMUEL BUCHMAN, Deceased,

Petitioners,

-against-

AMERICAN FOAM RUBBER CORP., MILTON R. ACKMAN, as Trustee of American Foam Rubber Corp., Bankrupt,

Defendants,

MARIE LOUISE deMONTMOLLIN, ALEXANDER F. PATHY and SUZANNE M. PATHY,

Defendants-Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE SUPREME COURT OF THE UNITED STATES

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OTHER SOURCES:

Calligar, 70 Yale Law Journal 376 5

Coogan, Kripke & Weiss, 79 Harvard Law Review 229 8

Remington Bankruptcy, Sec. 2874 at 486 (5th Ed., 1952) 10

IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No.

FIRST NATIONAL BANK OF HOLLYWOOD, DOROTHY BUCHMAN and SANDER BUCHMAN, as Executors of SAMUEL BUCHMAN, Deceased,

Petitioners,

-against-

AMERICAN FOAM RUBBER CORP., MILTON R. ACKMAN, as Trustee of American Foam Rubber Corp., Bankrupt,

Defendants,

MARIE LOUISE deMONTMOLLIN, ALEXANDER F. PATHY and SUZANNE M. PATHY,

Defendants-Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE SUPREME COURT OF THE UNITED STATES

TO: THE HONORABLE, THE CHIEF JUSTICE OF THE UNITED STATES, AND THE ASSOCIATE JUSTICES OF THE UNITED STATES SUPREME COURT

Petitioners, Dorothy Buchman and Sander Buchman, as Executors of Samuel Buchman, deceased, respectfully pray that a writ of certiorari issue to review so much of the order of the Circuit Court of Appeals which reversed a portion of the Judgment entered in the Southern District Court in favor of Petitioners which was based upon the conversion of the subordinated debt, to wit: debentures to stock, without the consent of the senior creditor, thus preventing the senior creditor from receiving the subordinated creditor's dividend in bankruptcy.

The review is also requested because of the failure of the Circuit Court to sustain the same portion of the Judgment, on the theory that the acts of defendant resulted in "payment" under the subordination agreement.

OPINIONS BELOW

The opinion of the Second Circuit Court is set forth in the Appendix. The opinion of the United States District Court is also set forth in the Appendix and is reported in 306 F. Supp. 593.

JURISDICTION

The jurisdiction of this Court is invoked under 28 U.S.C.A. Section 1254(1).

QUESTIONS PRESENTED

The issue and its determination in this case is one of first impression in this Court. It was also one of first impression in the Circuit Court of Appeals.

The question usually arises in the field of investments and banking and particularly in the use of subordination

agreements. In our case it is a subordination agreement as part of a "buy-out" by one stockholder of a second, wherein one subordinates her debentures (hereafter called subordinator) to the debentures of the other (hereafter called senior creditor).

The subordination agreement in our case is a "Complete" Subordination Agreement as contrasted with a less complete, sometimes called "Inchoate Agreement."

The subordinator, owner of 90% of the stock of the debtor, unilaterally converted her debentures two years prior to the bankruptcy of the debtor. She accepted capital stock of the debtor in lieu of the debentures. The senior creditor had not consented. As a result, the subordinator, no longer a general creditor of the debtor, was not entitled to a dividend in the bankruptcy.

The Circuit Court (and all other decisions) hold that but for the conversion, the senior creditor would be legally entitled to the subordinator's dividends upon the basis of the subordination agreement in our case.

The District Court held that the subordinator is liable to the senior creditor in an amount measured by what the dividends would have been but for the unilateral conversion and change of status.

The Circuit Court held that absent a specific contract clause prohibiting a conversion, the subordinator is not liable.

Your petitioner's position is that the holding renders the subordination agreement in good part a nullity and encourages a breach of contract or obligation.

Aside from a contract breach, the conversion resulted in payment, i.e. a discharge of an indebtedness, and is a further basis for a recovery.

STATEMENT OF THE CASE

All the necessary facts appear in the opinions of Judge Cooper in the District Court and of Judge Van Graafland in the Circuit Court.

The subordination agreement in our case (Appendix C) does not permit a unilateral amendment thereof.

In view of the Circuit Court's holding that absent a specific covenant prohibiting the conversion of the debentures into stock (changing her status of general creditor, hence no right to dividends in a bankruptcy) that she may do so, it is essential that we discuss *Complete* as distinguished from *Inchoate* Subordination Agreements.

We believe that the Circuit Court's opinion failed to distinguish between the Complete and the Inchoate, hence its incorrect determination.

A Complete Agreement has been defined as one in which a junior creditor (subordinator) agrees to postpone all payments that are now due or to become due until after payment to the senior creditor.

> *Calligar,* 70 Yale Law Journal 376;
> *Coogan, Kripke & Weiss,* 79 Harvard Law Rev. 229 at p. 234;
> *Pioneer Cafeteria Feed Ltd. v. Mack,* 340 F. 2d 719;
> *Judge Cooper,* U.S.D.J. 309 F. Supp. 547.

On the other hand, where

> interest and principal may be paid to the subordinator unless insolvency or bankruptcy accurs, the subordination agreement is stated to be *Inchoate.*
>
> *Coogan, Kripke & Weiss, supra.*

Calligar, 70 Y.L.J. 376 at pg. 378, states it somewhat differently, to wit:

> An *Inchoate* Subordination Agreement is one that does not become operative until a voluntary or involuntary distribution of assets of the debtor is made . . . thus the specific event which triggers the subordination, such as bankruptcy, will be specified in the agreement; and until such time, the debt may (or may not) be amortized, payments made to a sinking fund, may be redeemed or refunded as per the specific language of the agreement.

On the other hand, a *Complete* Agreement is one which:

> provides that no principal or interest may be paid on the subordinated debt so long as the senior creditor had not been paid.

The inescapable conclusion is that a *Complete* Agreement is complete against all and every contingency without any additional covenants by the subordinator or absent any limitations as to applicability. At least that is the view of Messrs. Calligar and Coogan, Kripke and Weiss. It is noteworthy that Mr. Calligar is quoted extensively in all decisions.

Mr. Calligar then proceeds to a development of the character of the "rights" of the senior creditor, 70 Y.L.J. 376 at pg. 378 (in addition to differentiating *Complete* and *Inchoate* Agreements,) stating:

Both Inchoate and Complete Subordination Agreements

> "have the practical effect of making the subordinated debt a kind of security for the senior debt, available to the senior creditor upon a distribution of the assets of the debtor."
>
> In the case of the Inchoate Subordination, the "security" may decrease or even vanish because payments are permitted on the subordinated debt. *In the case of the complete subordination, however, the subordinated debt is "locked-in" and its distributional value in bankruptcy becomes in*

effect just as much a security benefitting the senior debt holder as would, for example, a chattel mortgage in the hands of the foreclosing mortgagee."

"Since a complete subordination agreement provides unequivocably that payment may not be made on the subordinated debt until the senior debtor is paid in full, a proviso that specifically provides that the subordination shall only be effective in the event of a distribution of debtor's assets or its bankruptcy would change the agreement from a complete to an inchoate subordination agreement. *Calligar* (at pg. 383)

Calligar discusses the "rights" of the senior creditor from the view of the subordinator unilaterally amending the agreement to the detriment of the senior creditor, saying:

"Although the Courts would probably sustain the rights of senior debt created in reliance on the unamended subordination, on the ground of estoppel or that equities or rights had vested in the holder of the senior debt which would enable him to prevent an amendment injurious to his position, the courts might well have some difficulty in so holding if the indenture itself allowed for amendments." *Calligar*, Pg. 398.

What difference, in effect, then, in the case of an agreement providing for no amendments (our case) and the unilateral act of the subordinator rendering the agreement nugatory? Do not the equities or rights vested in the senior debtor estop the subordinator? We submit it does.

In a complete subordination agreement, it is not necessary to provide against the subordinator taking some security for the subordinated debt or against the subordinator converting the subordinated debt into capital stock. *Calligar*, Pg. 399.

In our case, there was no such right given the subor-

dinator. *Calligar* further says:

"As a result of the exercise by debenture holders for example, of their option to convert subordinated debentures, the theretofore subordinators would now be stockholders, rather than unsecured creditors, and would not share in the debtor's assets with the senior debtor in the event of a distribution to creditors. The senior debt would thus fail to receive the dividends that would have been paid to these subordinating creditors." *Calligar*, Pg. 399.

It is clear from *Calligar* that where there is a complete subordination agreement, language permitting subordinators to convert debentures to stock can hurt the senior debtor but absent such permission, the subordinator may not do so.

There need be no language prohibiting the conversion, in our view.

As we see it, the Circuit Court failed to distinguish between a Complete Agreement giving no specific right to conversion and an Inchoate Agreement which does.

We point out once again that the Circuit Court itself acknowledges that under our agreement we had a "contractual and equitable" right to the subordinator's dividends in bankruptcy.

If so, what happened to these rights?

Were these rights that could come to fruition only if the subordinator did not destroy them by conversion? If they are rights subject to unilateral divestiture, is it not more logical to require the agreement to so state? We think so.

It may be that the Circuit Court and other courts and legal scholars have devoted time and effort in discussing what a subordination agreement is not. We submit that not enough attention has been devoted to what the rights and

obligations between subordinator and senior creditor are, as contrasted to the considerable attention given to the rights of the senior creditor vis a vis other creditors of the subordinator or creditors of the common debtor of subordinator and senior creditor.

In determining the duties and obligations vis a vis the subordinator to the senior creditor, it is not fruitful to compare the type of debt held by the subordinator or the senior creditor. To make such comparison is to determine the nature of the debt the common debtor owes to them both.

The nature of the debt sheds no light on the duties and obligations of the subordinator to the senior creditor.

Nor does a determination of the relationship between the senior creditor and third parties help shed any light on the duties and obligations vis a vis the subordinator and the senior creditor.

Typical is the case of *Wyse vs. Pioneer Cafeteria Feeds Ltd.*, 340 F. 2d 719 (6th Cir.). The court pointed out that it was not determining the rights of subordinator vis a vis senior creditor but between those of the subordinator's creditors represented by a Trustee in bankruptcy and the senior creditor.

Thus, to say that the senior creditor has or has not acquired a recordable or non recordable "security" interest under Article 9 of the Uniform Commercial Code does not help our discussion. The reason is that Article 9 of the U.C.C. is concerned with secured interests which have priority over general creditors and not with the rights of the senior creditor against the subordinator.

Coogan, Kripke & Weiss, 79 Harvard Law Review 229 (1965)

Nor does the problem of what are the rights and

obligations of subordinator and senior creditor receive complete or definitive clarification by declaring that the senior creditor did not acquire an "equitable lien", "equitable assignment", or "a constructive trust as a consequence of the subordination agreement." The above legal concepts are usually applied to a rationale by some courts in bankruptcy to allow the senior creditor to take the bankruptcy dividend otherwise payable to the subordinator. Where these legal concepts are rejected, other rationales are assigned to give the senior creditor the same rights. But uniformly all cases have awarded the senior creditor the dividends in bankruptcy otherwise payable to the subordinator. This is conceded by the Circuit Court in our case, stating:

> "Clearly, the senior creditor had both equitable and contractual rights in the proceeds of such payments. Similar rights would attach to dividends in the estate of the bankrupt creditor. In re Credit Industrial Corp., 366 F. 2d 402 (2d Cir., 1966); Calligar, Subordination Agreements, 70 Yale L.J., 376, 383 (1961)."

The Circuit Court further stated that the basis (in the 2d Circuit) for the senior creditor's rights to the dividends, is to be found in the contract, namely the subordination agreement. (Appendix A).

The Second Circuit (Re Credit Industrial Corp., 366 F. 2d 402) refers to the "consensual or contractual subordination" as the basis for priority among debts, and rejects the need of invoking "equitable estoppel".

This "consensual or contractual" subordination, absent specific language giving the subordinator's dividend in bankruptcy to the senior creditor (Re Credit Industrial Corp., supra at pg. 912, 2nd Par.) must have been derived from the inferred "right" given by the Complete subordination Agreement.

"Moreover, the subordination provisions are all encompassing and precluded payment to the holder whenever there is an unsatisfied outstanding senior debt. Any reference to bankruptcy proceedings would have been superfluous in view of the broad terms of the subordination provisions. Cf. In re Aktie, Bolaget, Kreuger & Toll, supra, 96 F. 2d at 770.

A review of the cases in the bankruptcy court, granting recovery by the senior creditors of the dividends otherwise payable to the subordinator, are unanimous in outcome[1], but very diverse in basis of recovery. They evince a compelling conclusion that the inherent or implicit "rights" of the senior creditor require the conclusion reached. They bespeak a tacit understanding that one of the main purposes of subordination is the senior creditor's right to the subordinator's dividends in bankruptcy.

We believe that the Circuit Court may not have differentiated between an equitable right and an equitable lien, when it held that the senior creditor's rights in the subordination agreement was not a *lien*. This approach is directed solely to the debt itself and not to the subordinator. An equitable right (rather than lien) properly reduces the situation to a personal rather than a property focus.

Nor can we reconcile the "contractual" rights, rights which are implicit (by the law merchant, by the conduct and understanding in the credit field), from the contract itself. The District Court Judge saw this as an "implied" right. It must be a right because the credit field conducted itself upon the assumption that it is implicit in the agreement.

1. *Calligar*, Y.L.J. 376 at 390, citing P. Schinzel & Son, 16 F. 2d 289. *Brooklyn Trust Co. vs. Fairfield Gardens*, 260 N.Y. 16 at p. 21. *Remington, Bankruptcy*, Sec. 2871 at 486 5th Ed., 1952.

As previously stated, the Second Circuit (*Matter of Credit Ind. Corp. Bankr.*, 366 F. 2d 402), did not refer or rely upon the Subordination Agreement, but instead said:

"It is frivolous to argue that the agreement failed to provide expressly that the agreement applied in bankruptcy."

In *Bank of American Nat'l Trust Sav. Assn. vs. Erickson*, 117 F. 2d 796 (9th Cir.), the Court stated:

"the subordination debt is "locked in" and its distributional value in bankruptcy becomes a security benefitting the senior debt holder."

In this 9th Circuit case, there was no specific language in the subordination agreement saying that the general debt may not be converted into capital stock.

We also point out that the Circuit Court's reference to the fact that Marie Louise deMontmollin did not become unjustly enriched, nor was her act a "scheme or bad faith in contemplation of the bankruptcy" fails to take cognizance of at least one other vital consideration and protection usual to a subordination agreement.

In our case it is clear that before Buchman and Marie Louise deMontmollin entered into the "buy-out" agreement, each had approximately equal stock control of American Foam Rubber; that previously Buchman was President and thus had "control" over operation and policy; that Buchman held $110,000 and Marie Louise de Montmollin held $143,000 in American Foam Rubber debentures. Buchman thus previously had a true and real hand in molding the direction of American Foam Rubber.

After the "buy-out" agreement, Marie Louise de Montmollin was to all intents and purposes the holder of 100% stock in American Foam Rubber. She controlled it and her actions and purposes were that of a "single owner enterprise."

When Buchman left, he knew the liabilities of American Foam Rubber and who and how and when any creditor could preempt him in the enforcement of rights and remedies against A.F.R. This was what he bargained for.

He knew that Marie Louise de Montmollin could not. That is what he bargained for.

When Marie Louise de Montmollin surrendered her debentures and accepted stock for the ostensible reason that thereby American Foam Rubber could borrow further monies, two things happened.

First, the $143,000 debenture debt, which in Marie Louise de Montmollin's hands was immobolized in action, became an imminent lien debt in the hands of a money lender, a factor. It did not suffice that new money came into A.F.R. because it was not used to pay Buchman. It also changed the nature of A.F.R.; it made it more potential to failure and bankruptcy if the new venture capital were used in ways neither approved by Buchman or as experience showed, in a non economically viable and productive manner.

Second, Buchman lost his right to take Marie Louise de Montmollin's dividends on $143,000 debentures, since Marie Louise de Montmollin lost her creditor status. Buchman did not bargain for either happening.

THE CONVERSION OF THE DEBENTURES TO CAPITAL STOCK OF DEBTOR, CONSTITUTED PAYMENT

The subordination agreement might have provided that conversion from debenture to corporate stock of debtor is prohibited. Had it so provided, it would have diminished the wholeness of the Complete Subordination

Agreement, which by definition covers all by lack of restriction or additional conditions.

Would not the same result be reached by judicial interpretation that a Complete Agreement implies a conversion subverts the agreement and results in payment?

The following elaboration, on other grounds, supports such judicial interpretation.

We submit that "payment" is the end result of acts, the conclusion to be drawn from them, and not the acts per se.

We submit that "payment" results from acts, that is, a surrender of the debentures and their cancellation and acceptance of stock; hence payment to the debenture holder resulted.

That the payment was not effected by a cash payment or payment in cash, is not material. Essential is that the obligor performed its obligation and the obligee was content with what she received. The criterion is a discharge.

Moseley vs. Calhoun, 7 Circ. Ct R.N.S. 285 (Ohio)
Beals vs. Home Insurance Co., 36 N.Y. 522
In Re Gray's Estate, 160 Misc. 710, 290 N.Y.S. 603
First Citizens Bank & Trust Co. vs. Speaker, 159 Misc. 427, 287 N.Y.S. 831
In Re Montague v. Bank of N.Y., 94 A.D. 219, 88 N.Y.S. 21
Carpenter vs. Dummit, 287 S.W. 695, 700
Hopson vs. Aetna Axle, 50 Conn. 597, 601
Chase National Bank vs. Schleussner, 117 Conn. 370, 167 Atl. 808

The Court in *Arkansas Fertilizer vs. U.S.*, 193 F. 667 at 673 in interpreting the word, "pay," said:

"It should not be interpreted in the narrow sense of a money transaction; it is equally a payment . . . to

be relieved from an obligation which the law imposes."

The receipt by the creditor of money or "some other valuable thing," extinguishes the debt and is payment.

Moses vs. U.S., 28 F. Supp. 817
Chrysler Corp. vs. Hanover Ins. Co., 350 F. 2d 652, 656
Thomas vs. Board of Review, 199 Atl. 2d 33, 36
U.S. vs. Isthmian S/S Co., 359 U.S. 314, 79 S.Ct. 857.

Thus, although plaintiff should thus be entitled to recover not only $11,000 plus (in lieu of dividends) plaintiff was really entitled to a full recovery up to its $65,000 claim. This follows from the terms of the agreement itself.

REASONS FOR GRANTING WRIT

The legal issue in this case is one of first impression.

Untold number of subordination agreements now extant are seriously affected.

The Decision of the Court of Appeals conflicts with the philosophy, commercial and legal, of the developmental subordination agreement usages, decisions and writings.

The Court of Appeals Decision does an injustice in this case and encourages breaches of obligations.

The Decision of the Circuit Court is in conflict with the Decision rendered in the Ninth Circuit (Bank of America Nat'l Trust Sav. Assn. vs. Erickson, 117 F. Rep. 796) and contrary to the commercial and historical development of the subordination agreements and judicial holdings.

In Re Credit Indus Corp. Bankrt., 366 F. Rep. 2d 402.
Cherno vs. Dutch Amer. Merc. Corp., 353 F. Rep. 2d 146.

Calligar—Subordination Agreements, 70 Yale Law Journal 376
In Re Aktie. Bolaget. Kreuger & Toll, 96 F. 2d 768
Coogan, Kripke & Weiss, 79 Harvard Law Review 229
Pioneer Cafeteria Feeds Ltd. vs. Mack, 340 F. 2d 719 (10th Cir.)
Dodge-Freedman Poultry vs. Delaware Mills, 148 F. Supp. 617, aff'd 244 F. 2d 314 (1st Cir.)
Peoples Ticonic Bank vs. Stewart, 86 F. 2d 359.

The Circuit Court's failure to view the discharge by the subordinated creditor of the debentures and the acceptance in lieu thereof of stock of the same corporation constituted "payment" of the debentures, is in conflict with:

Arkansas Fertilizer vs. U.S., 193 F. 667
Moses v. U.S., 28 F. Supp. 817
Chrysler Corp. vs. Hanover Ins. Co., 350 F. 2d 652
U.S. vs. Isthmian S.S. Co., 79 S. Ct. 857, 359 U.S. 314

The Circuit Court's order will adversely affect the rights and remedies of banks, factors and businessmen who presently have outstanding subordination agreements.

CONCLUSION

Thus, we submit, the *Complete* Subordination Agreement gives rights, inherent and implicit, rights accepted as such by the marketplace and the contracting parties, which rights may be (but need not be) held to be "locked in" ab anitio upon the making of the Subordination Agreement; "locked in" as a "security" to the senior creditor (Calligar).

Such right is destroyed by a holding that the subordinator may unilaterally amend (by change) the agreement by converting the subordinated debt (debentures) to capital stock of the debtor.

A recovery on the theory of "payment" to the subordinator is also indicated.

A Petition for Certiorari should be granted.

Respectfully submitted,

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Appendix

Appendix A—Opinion of the Circuit Court

UNITED STATES COURT OF APPEALS
For the Second Circuit

No. 38—September Term, 1975.
(Argued September 24, 1975 Decided February 5, 1976.)
Docket No. 75-7051

FIRST NATIONAL BANK OF HOLLYWOOD, DOROTHY BUCHMAN and SANDER BUCHMAN, as Executors of SAMUEL BUCHMAN, Deceased,

Plaintiffs-Appellees,

v.

AMERICAN FOAM RUBBER CORP., MILTON R. ACKMAN, as TRUSTEE OF AMERICAN FOAM RUBBER CORP., Bankrupt,

Defendants,

MARIE LOUISE deMONTMOLLIN, ALEXANDER F. PATHY and SUZANNE M. PATHY,

Defendants-Appellants.

Before:

LUMBARD, MULLIGAN and VAN GRAAFEILAND,

Circuit Judges.

Appeal from a judgment of the United States District Court for the Southern District of New York, Irving Ben Cooper, J., awarding plaintiffs damages for breaches of a subordination agreement.

Affirmed in part and reversed in part.

DAVID SIVE, New York, N.Y. (Winer, Neuburger & Sive, New York, N.Y., on the brief), *for Defendants-Appellants.*

JACOB HELLER, New York, N.Y. (Joseph Heller & Jacob E. Heller, New York, N.Y., on the brief), *for Plaintiffs-Appellees.*

VAN GRAAFEILAND, *Circuit Judge:*

This is an appeal from a judgment in favor of the executors of one corporate creditor against another corporate creditor whose right to receive payment was made subordinate to that of plaintiffs' testate. Two questions are presented:

1. Did the subordinated creditor have the right to discharge an unmatured subordinated indebtedness without the consent of the senior creditor?

2. Was there payment of a matured, subordinated debenture when the subordinated creditor took the note of the debtor's parent corporation instead of cash?

Litigation between the parties has now been in progress for fifteen years, and three opinions of the District Court have been reported. *Buchman v. American Foam Rubber Corp.*, 250 F.Supp. 60 (S.D.N.Y. 1965); *First National Bank v. American Foam Rubber Corp.*, 306 F.Supp. 593 (S.D.N.Y. 1969); *First National Bank v. American Foam Rubber Corp.*, 309 F.Supp. 547 (S.D.N.Y. (1969).[1] Repetition will not improve upon the recitals of fact contained in these opinions, and we will therefore review

1. The pertinent opinion for purposes of this appeal is reported at 306 F. Supp. 593.

only so much background as is necessary to frame the issues on this appeal.

Prior to 1957, appellees' testate, Samuel Buchman, was president and a substantial stockholder of American Foam Rubber Corp. (AFR), a New York corporation. On May 17, 1957, Buchman resigned and sold his interest in AFR and its affiliate, Burlington Holding Corporation, to appellants. As part of the agreement of sale, certain debentures of the two corporations, maturing in 1960 and 1965, which were held by appellants, were subordinated to debentures held by Buchman. The pertinent portion of the subordination agreement reads as follows:

> To induce Samuel Buchman to sell his capital stock hereunder, Marie Louise deMontmollin and Alexander F. Pathy hereby agree with respect to the debentures of each of said corporations that the rights of any holder (including her or him) of the debentures thereof now held by her or him and referred to above, be subordinated to the rights of any holder or holders of the debentures thereof now held by Samuel Buchman (including him) as to the payment of interest and principal. No claim for interest under the debentures so subordinated shall be made unless all interest payable on the debentures now held by Samuel Buchman shall have been paid in full, and no claim for principal under any of the debentures so subordinated shall be made unless the entire principal of all the debentures now held by Samuel Buchman shall have been paid in full.
>
> If for any reason, either corporation shall pay interest or principal on said debentures to any of the Buyers, or to any person deriving title to the debentures of said corporation from any of the Buyers, and said payment shall be made without first satisfying the priority to which the holder or holders of Samuel Buchman's debentures are entitled by reason of the foregoing provisions, the

amount or amounts of the payment so made to the Buyer (or to the person deriving title from her or him) shall be promptly paid by such Buyer to said holder or holders of Samuel Buchman's debentures.

A similar agreement of subordination was made with respect to some corporate promissory notes which were held by the parties.

In 1958, AFR decided to issue new stock for the purpose of improving its capital structure; and, over a period of time, appellant deMontmollin surrendered subordinated AFR debentures and notes with a face value of $322,000 for preferred stock with an equivalent face value.

On April 1, 1960, the Burlington debentures became due. Buchman was paid in cash for his, and Mrs. de Montmollin received a credit on Burlington's books for $15,000, the amount of her debentures. She immediately loaned this money to AFR, receiving a promissory note in return.[2] This was accomplished by a bookkeeping transfer of assets from Burlington to AFR; no money passed through appellants' hands.

On February 21, 1961, AFR was adjudicated a bankrupt. In its opinion, 306 F.Supp. 593, 601, the District Court stated that, if Mrs. deMontmollin had not surrendered the $322,000 in debentures and notes, appellees, because of their right to priority in payment under the subordination agreement, would have been entitled to recover the bankruptcy dividends payable on these obligations. It therefore held appellant deMontmollin liable for the amount of the dividend which would have been paid. The District Court also held that the transaction involving the $15,000 Burlington debentures constituted payment of those debentures within the meaning of the

2. Burlington had become a wholly owned subsidiary of AFR in 1958.

subordination agreement and that appellant deMontmollin was liable for this amount. *Id.* at 607.

We reverse the holding of the District Court insofar as it predicates liability upon the exchange of the AFR debentures and notes for stock and affirm its holding insofar as it predicates liability upon the payment of the Burlington debentures.

The Exchange Transaction

Before examining the District Judge's theory of liability, we first note our approval of his rejection of an alternate theory which had been proposed by plaintiffs. Judge Cooper held that the exchange of debentures and notes for preferred stock did not constitute payment of these obligations, as that term was used in the subordination agreement, since no assets of the corporation passed into the creditors' hands. 306 F.Supp. at 599. Neither, he said, was the issuance of stock the first step in a plan to secure payment, since AFR was precluded by other contractual provisions from paying dividends or redeeming stock. *Id.* at 600. We find no error in these holdings.

Judge Cooper's theory of liability was that appellant had breached an implied provision in the subordination agreement that the subordinated debt would not be discharged.[3] He stated that the subordinated debt was "a

3. Appellants claim that Judge Cooper abused his discretion by basing his decision on an implied provision not to discharge the indebtedness because that theory was not pleaded by any of the parties and contradicted previous rulings by the court that allegedly limited the issues to be tried. While these allegations would provide sufficient grounds for reversal if Judge Cooper had, as implied by appellants, raised and resolved issues *sua sponte* that prejudiced appellants, *see United Transportation Union v. State Bar of Michigan*, 401 U.S. 576 (1971); *Reynolds v. Stockton*, 140 U.S. 254, 266 (1891), in this instance Judge Cooper was entitled to consider the claim of the loss of a "double dividend" in bankruptcy.

On May 9, 1967, Judge Cooper issued an opinion denying defendants'

type of security for the senior debt, available to the senior citizen upon a distribution of the assets of the debtor" and might therefore be regarded as a "cushion" or "support" for the senior debt. 306 F.Supp. at 599. Although he then specifically refused to determine the true nature of the interest, "if any", created in favor of the senior creditor, he held that, in the absence of provisions to the contrary, it

3 (Continued)

motion for summary judgment on the subordination claim. Judge Cooper defined the "plain meaning" of the subordination agreement as prohibiting defendants "from realizing any cash or its equivalent from the corporation until Buchman's debentures had been satisfied in full." Judge Cooper indicated that the Exchange Transactions would not violate the subordination agreement thus defined unless it constituted "a first step in a plan to obtain cash—or cash realizable property—from the corporation." It was to decide this latter question that Judge Cooper proceeded to trial.

After a three-day trial to the court in December 1968, Judge Cooper rendered his decision on July 23, 1969. With respect to the Exchange Transaction, he held that the discharge of the debentures and receipt of the preferred stock did not constitute "payment" within the meaning of the subordination agreement. 3;6 F Supp. at 599-600. Judge Cooper also determined that the exchange was not a first step in a plan to obtain cash that could constitute a breach of the agreement under the May 9, 1967, interpretation. Nevertheless, the judge concluded that the Exchange Transaction breached the agreement because it deprived Buchman of his "double dividend" in bankruptcy. Since Judge Cooper had indicated in his opinion of May 9, 1967, that the subsequent trial would be limited to the question of whether the Exchange Transaction constituted the first step in a plan to obtain cash, appellants forcefully argue that appellees were restricted by the law of the case to a recovery on the issue of premature payment. Thus, appellants argue, once the district court found no such payment, the inquiry should have ended and judgment should have been entered on their behalf.

Our reading of the record reveals that the "double dividend" theory was not based on an issue or on facts that the parties did not have the opportunity to litigate at trial and that Judge Cooper's consideration of the issue did not unduly prejudice appellants. At an early point during the first day of the trial, appellees offered evidence bearing on AFR's status in bankruptcy in order to prove the amount of the dividend that Buchman would have received in bankruptcy had appellants' debentures not been exchanged for stock. Appellees also noted that they had advocated this theory of recovery throughout the pretrial proceedings and this point was not denied by appellants. Thus, it appears that appellants were fully apprised of the "double dividend" issue both prior to and during the trial and could have introduced evidence to the effect that the parties never intended the subordination agreement to cover the parties' rights in bankruptcy, had that indeed been the understanding. No such evidence was offered.

The fact that the relief requested in the pleadings did not include the lost

was a breach of the subordination agreement for the junior creditor to discharge the subordinated debt. *Id.* at 606. We disagree.

The subordination agreement provided in substance that neither interest nor principal should be paid on the subordinated debt unless the interest and principal on the senior debt were paid in full and that, if such payments were made, they would be promptly paid over to the senior creditor. Clearly, the senior creditor had both equitable and contractual rights in the proceeds of such payments. Similar rights would attach to dividends declared in the estate of the bankrupt creditor. *In re Credit Industrial Corporation,* 366 F.2d 402 (2d Cir. 1966); Calligar, *Subordination Agreements,* 70 Yale L.J. 376, 383 (1961).

Various theories have been advanced to support the enforcement of subordination agreements in bankruptcy: equitable lien, equitable assignment, constructive trust and enforcement of contractual rights. *In re Itemlab Inc.,* 197 F.Supp. 194, 197 (E.D.N.Y. 1961); Calligar, *supra,* 70 Yale L.J. at 384; Leiby, *Enforcement and the U.C.C.,* 23 Bus.Lawyer 57 (1967). This Circuit has favored the

3 (Continued)

dividend would not preclude Judge Cooper from granting relief on that theory. The pleadings recited all the facts relevant to the Exchange Transaction and appellants cannot have been surprised by the evidence proffered at trial. Once the issue was raised at trial, Judge Cooper was entitled to grant relief on a theory not pleaded by any party but relying on pleaded and proven facts. *See United States ex rel. Bergen Point Iron Works v. Maryland Casualty Co.*, 384 F.2d 303, 304 (2d Cir. 1967); Fed. R.Civ. P. 54(c); 10 C. Wright & A. Miller, *Federal Practice and Procedure* §2664, at 104-05 (1973).

Nor can we say that Judge Cooper's May 9, 1967 decision irrevocably bound him not to consider the parties' rights in bankruptcy at the subsequent trial. In this Circuit, the law of the case is a discretionary doctrine that need not be applied when no prejudice results from its omission. *See Dictograph Products Co. v. Sonotone Corp.*, 230 F.2d 131, 135 (2d Cir.), *appeal dismissed*, 352 U.S. 883 (1956). Since appellants were on notice both prior to and during the trial that appellees would request judgment on the basis of the dividend lost as a result of the Exchange Transaction, the appellants did not suffer prejudice or surprise such as to render it improper for the district court to reach that question.

recognition of priorities based upon the "lawful contractual arrangement between the parties." *In re Aktiebolaget Kreuger & Toll*, 96 F.2d 768, 770 (2d Cir. 1938). As we stated in *In re Credit Industrial Corporation, supra*, 366 F.2d at 407, if the terms of the contract are unambiguous, there is no need to resort to "strained theories of third-party beneficiary, estoppel or general principles of equity" to determine the rights of the parties.

Since most of the decisions in this area have dealt with the priority of payments in bankruptcy, there has been little need for the courts to explore the rights of the parties beyond those which attach to the bankruptcy dividends. The rules which have been laid down in these cases are not, therefore, determinative of the senior creditor's pre-bankruptcy rights, if any, in the payment which has not yet accrued or the dividend which has not been declared, *i.e.*, in the debt itself.[4] To justify the judgment in favor of plaintiffs below, they must have had rights, rights of such nature that they precluded defendant's good faith discharge of the subordinated debt.

No recital of such rights can be found in the contractual arrangement between the parties. The terms of the subordination agreement are unambiguous and include no prohibition against discharge of the subordinated indebtedness. Moreover, based upon our decision in *Cherno v. Dutch American Mercantile Corporation*, 353 F. 147 (2d Cir. 1965), we see no equitable basis for holding that a prohibition should be implied.

The facts in *Cherno* are not dissimilar from those we are now considering. There, the subordinated creditor

4. "Cases in this area are not helpful in solving the question of whether the subordination, if it is a lien or assignment, is a lien or assignment of the note itself or of certain rights arising by virtue of the note." Zinman, *Under the Spreading UCC-Subordinations and Article 9*, 7 B.C. Ind. & Com. L. Rev. 1, 25 n. 81 (1965).

discharged a chattel mortgage which he held as security, in order that the debtor could mortgage the property to a third party. In denying the senior creditor's claim that it was a preferred lien creditor as an equitable assignee or equitable lien holder, we held that the usual subordination agreement simply gives priority or precedence of lien right and debt payment to the senior creditor and does not constitute an assignment of the subordinated debt. *Id.* at 151. We also rejected the senior creditor's claim of a security interest in the debt. In so doing, we anticipated the provisions of §1-209 of the N.Y. Uniform Commercial Code, enacted the following year.[5] Finally, we held that the senior creditor was not the beneficiary of a constructive trust, because the subordinated creditor was not being unjustly enriched by holding property in which the senior creditor had an interest.

In denying the existence of an equitable lien in, or equitable assignment of, the subordinated debt, we were following rules of law well established in both the New York and Federal courts. Generally, these courts have held that an agreement to pay out of a particular fund does not create an equitable lien upon the fund or operate as an equitable assignment thereof. *East Side Packing Co. v. Fahy Market*, 24 F.2d 644, 645 (2d Cir. 1928); *Union Trust Co. v. Townshend*, 101 F.2d 903 (4th Cir.), *cert. denied*, 307 U.S. 646 (1939); *B. Kuppenheimer & Co. v. Mornin*, 78 F.2d 261, 264 (8th Cir.), *cert. denied*, 296 U.S. 615

5. N.Y. Uniform Commercial Code § 1-209 (McKinney Supp. 1975) provides:

> An obligation may be issued as subordinated to payment of another obligation of the person obligated, or a creditor may subordinate his right to payment of an obligation by agreement with either the person obligated or another creditor of the person obligated. Such a subordination does not create a security interest as against either the common debtor or a subordinated creditor. This section shall be construed as declaring the law as it existed prior to the enactment of this section and not as modifying it.

(1935); *Cabell v. Markham*, 69 F.Supp. 640, 642 (S.D. N.Y. 1946), *aff'd sub nom. Cabell v. Clark*, 162 F.2d 153 (2d Cir. 1947); *People ex rel. Balbrook Realty Corp. v. Mills*, 295 N.Y. 190, 195 (1946). To accomplish an assignment, the would-be assignor must relinquish control over the fund. The test is whether there is "an appropriation of the fund so that the debtor would be justified in paying the debt or the assigned part to the person claiming to be the assignee." *Hinkle Iron Co. v. Kohn*, 229 N.Y. 179, 183 (1920); *In re Conoley*, 50 F.Supp. 542 (S.D.N.Y. 1942).

Whatever may have been the situation with regard to payments due and owing to Mrs. deMontmollin, we think it clear from the foregoing authorities that Mr. Buchman, as senior creditor, had no equitable rights as assignee or lienholder in the debt itself. *Thomas v. New York and Greenwood Lake Rwy. Co.*, 139 N.Y. 163, 178 (1893). AFR, the debtor, had no right to pay any part of the unmatured debt to Mr. Buchman, the senior creditor.

It is interesting to note that this was the specific holding of the court in *In re Dodge-Freedman Poultry Co.*, 148 F.Supp. 647 (D.N.H. 1956), *aff'd sub nom. Dodge-Freeman Poultry Co. v. Delaware Mills Inc.*, 244 F.2d 314 (1st Cir. 1957), (per curiam) relied upon by the court below. That case involved the waiver by a subordinated creditor of a bankruptcy dividend and the preservation of such dividend for the senior creditor through the doctrine of constructive trust. The court said, 148 F.Supp. at 651:

> In the case at bar, there was no manifestation of intention, either written or oral, or by conduct, on the part of Freedman [the subordinated creditor] to relinquish control, or to make any appropriation to Delaware Mills, Inc. [the senior creditor]. Therefore, no equitable assignment was created, nor is there an equitable lien.

Judge Cooper quite correctly recognized, on the basis of our decision in *Cherno*, that plaintiffs could claim no rights as beneficiaries of a constructive trust, since Mrs. deMontmollin never had any property in her possession in which plaintiffs had any equitable interest. 306 F.Supp. at 603 n.38. Having thus rejected appellees' last possible equitable claim, it is not surprising that Judge Cooper would "initimate no view on the 'true nature' of the interest created, if any."[6] *Id.* at 606.

Judge Cooper's reliance upon a statement in *Cherno* that the subordinated creditor breached the subordination agreement when it discharged a chattel mortgage given to it as collateral, is, we think, misplaced. That statement was dictum. Moreover, the proof in *Cherno* showed that the collateral was discharged subsequent to default by the insolvent debtor on both the subordinated debt and the senior indebtedness, while an action to recover on the latter was pending. We described it as part of a "scheme" to get additional cash from an innocent lender. 353 F.2d at 149.

The discharge of the subordinated indebtedness in the instant case occurred before its maturity and three years prior to the debtor's bankruptcy. There is no claim of any "scheme" or bad faith and no contention that the discharge was made in contemplation of bankruptcy. Nonetheless, Judge Cooper determined in 1969 that the discharge constituted a breach of the subordination agreement and then waited five years until the termination of the bankruptcy proceedings in 1974 to compute the amount of plaintiffs' damages. Only in this way could he

6. A determination of the "true nature" of plaintiffs' equitable rights cannot be avoided by adopting the concept of implied contract. "[I]mplied contract is a term used to define those situations and conditions which make it equitable and just in applying the equity powers of the court to establish and declare a lien where otherwise there might be no relief." *James v. Alderton Dock Yards, Ltd.*, 256 N.Y. 298, 303 (1931).

ascertain the amount of the "double dividend" which he said plaintiffs lost.[7]

It requires little imagination to conceive of the discharge of a subordinated debt many years prior to bankruptcy, or, indeed, without any subsequent bankruptcy ever taking place. If the decision appealed from is correct, such discharge would nonetheless be a breach of the subordination agreement, because of the remote chance that bankruptcy might someday occur and the senior creditor might thereafter be deprived of a double dividend.[8] We think that if the senior creditor would prohibit a discharge because of such remote contingencies, he should so provide in the subordination agreement.

We hold, therefore, that appellees' testate had no equitable or contractual rights in the unmatured obligations which prevented appellant from discharging them in good faith.

The Loan Transaction

Appellant's argument that the loan transaction was simply a series of bookkeeping entries between parent and subsidiary corporation was properly rejected by the District Court. Where a creditor takes the bill, note or check of a third party instead of insisting upon performance to the letter of his contract with the debtor, a reasonable inference may sometimes be drawn that the primary obligation has been paid and discharged. *Hamilton v. R.S. Dickson & Co.*, 85 F.2d 107 (2d Cir. 1936); 70 C.J.S.

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7. Since we are reversing that portion of the judgment in which these damages are awarded, we need not consider appellant's argument that the procedure followed by the District Court was improper.

8. A breach under these circumstances would create interesting problems concerning the computation of damages and the running of the statue of limitations.

Payment §29 (1951). Judge Cooper was entitled to find that when upon the maturity of the Burlington debentures, Mrs. deMontmollin released that company from its indebtedness and took an AFR note in substitution therefor, this was payment of the debentures within the meaning of the subordination agreement. Moreover, although no money passed through appellant's hands, the effects of the transaction, as Judge Cooper held, were the same as if it had.

Plaintiffs were entitled to recover the amount of this payment by virtue of the specific provisions of the subordination agreement. This being so, we need not consider appellant's equitable defense of lack of clean hands, based on Mr. Buchman's allegedly improper conduct in other matters involving AFR.

We affirm that portion of the judgment appealed from which is based on the payment of the $15,000 in Burlington debentures and reverse that portion based upon the discharge of the $322,000 in AFR debentures and notes, with costs of the appeal to appellant, and remand to the District Court for judgment in accordance with this decision.

APPENDIX B

OPINION OF IRVING BEN COOPER, U.S.D.J. DATED JULY 23, 1969

(SAME TITLE)

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IRVING BEN COOPER, D.J.

American Foam Rubber Corporation (hereinafter AFR) was organized in 1950 under the laws of the State of New

York. From the time of organization until May 17, 1957, Samuel Buchman served as its president and operating head. On the latter date an agreement (hereinafter the Buy-Sell Agreement) was entered into between Buchman and the individual defendants, Alexander F. Pathy (hereinafter Pathy), Suzanne M. Pathy (Pathy's wife) and Marie Louise de Montmollin (also a relative), under the terms of which Buchman sold his entire stock interest in AFR and Burlington Holding Corporation (hereinafter Burlington)[1] to the individual defendants and resigned as an officer and director of AFR.[2] AFR's business was thereafter conducted by Pathy as president and the other individual defendants as officers and directors.

To induce Buchman to sell his capital stock, Pathy and deMontmollin agreed to subordinate certain debentures of the corporations then held by them to the rights of holders of specified debentures then held by Buchman. The terms of this subordination are embodied in subparagraph A of the SIXTH paragraph of the Buy-Sell Agreement:

> The parties named below hold five (5%) percent registered debentures issued by American Foam or Burlington in the following respective amounts:

1. Burlington became a wholly-owned subsidiary of AFR on April 30, 1958.

2. Under the terms of the Buy-Sell Agreement, Buchman's Son, A Sander Buchman, also sold his entire stock interest in AFR to the individual defendants.

NAME OF HOLDER	AMERICAN FOAM SERIES A DEBENTURE DUE MAY 1, 1960	AMERICAN FORAM SERIES B DEBENTURE DUE MAY 1, 1965[3]	BURLINGTON DEBENTURE DUE APRIL 1, 1960
SAMUEL BUCHMAN	$48,000	$64,000	$12,000
MARIE LOUISE de MONTMOLLIN	63,000	79,000	15,000
ALEXANDER F. PATHY	-0-	80,000	-0-

To induce Samuel Buchman to sell his capital stock hereunder, Marie Louise deMontmollin and Alexander F. Pathy hereby agree with respect to the debentures of each of said corporations that the rights of any holder (including her or him) of the debentures thereof now held by her or him and referred to above, be subordinated to the rights of any holder or holders of the debentures thereof now held by Samuel Buchman (including him) as to the payment of interest and principal. No claim for interest under the debentures so subordinated shall be made unless all interest payable on the debentures now held by Samuel Buchman shall have been paid in full, and no claim for principal under any of the debentures so subordinated shall be made unless the entire principal of all the debentures now held by Samuel Buchman shall have been paid in full.

If for any reason, either corporation shall pay interest or principal on said debentures to any of the Buyers, or to any person deriving title to the debentures of said corporation from any of the Buyers, and said payment shall be made without first satisfying the priority to which the holder or holders of Samuel Buchman's debentures are

3. "Due May 1, 1965" should read "Due August 1, 1965." See Exhibit 37 and the trial transcript at page 15.

entitled by reason of the foregoing provisions, the amount or amounts of the payment so made to the Buyer (or to the person deriving title from her or him) shall be promptly paid by such Buyer to said holder or holders of Samuel Buchman's debentures. Any payment made on account of principal shall be endorsed on said debentures, which shall be submitted to the payer for that purposes.

On June 1, 1957, Pathy sold his Series B AFR debentures to deMontmollin for $80,000 and received such amount from her in payment thereof. (PTO 39.)[4]

In April 1958, "the individual defendants in their capacities as officers, directors and stockholders of AFR caused the certificate of incorporation of AFR to be amended so as to provide for 3,500 shares of 5% cumulative preferred stock of the par value of $100 each . . . " (PTO 40.) At a special meeting of AFR's Board of Directors held on April 23, 1958, it was resolved that shares of the new 5% cumulative preferred stock be issued in exchange for AFR Series A and Series B debentures and 5% promissory notes surrendered to the corporation at the rate of one share of stock for each $100 face amount of said debentures and notes. (EX. FD.)[5]

In May 1958, deMontmollin surrendered AFR debentures and notes owned by her in the aggregate face amount of $291,000 to AFR and received in exchange therefor 2,910 shares of preferred stock. In December 1959, deMontmollin surrendered additional AFR debentures and notes in the total face amount of $31,000, which she owned, and received in exchange 310 shares of preferred stock. (PTO 40.)

4. "PTO" followed by a number refers to paragraphs of the Pre-Trial Order dated March 15, 1968.

5. "EX." followed by a number or letters refers to exhibits in evidence. "Tr." followed by a number refers to pages of the trial transcript.

On April 1, 1960, the Burlington debentures held by Buchman and deMontmollin became due. Buchman was paid the interest and $12,000 principal owing on his Burlington debentures on or about their due date. (PTO 38.) DeMontmollin's Burlington debentures in the amount of $15,000 were also discharged and she received a credit for that amount on Burlington's books. She then loaned this same $15,000 to AFR, then the parent company of Burlington, and received a note from AFR in that amount.

Buchman was paid the interest and principal amount owing on his Series A AFR debentures on or about their due date, May 1, 1960. (PTO 38.)

On January 17, 1961, AFR filed a voluntary petition for an arrangement under Chapter XI of the Bankruptcy Act and was duly adjudged a bankrupt on February 21, 1961. A Trustee in Bankruptcy was appointed on February 23, 1961. (PTO 2 and 3.) The Trustee has insufficient assets in his hands to pay in full the liabilities of said bankrupt. (PTO 5.)

While Buchman was paid interest on his Series B AFR debentures until and including August 1, 1960, he has been paid neither any part of the $64,000 principal nor any interest thereon falling due after August 1, 1960. AFR's Series B debentures were due on August 1, 1965. (EX. 37.)

Claiming breach of the subordination provisions of the Buy-Sell Agreement, Buchman instituted suit against the individual defendants in June 1960. (Buchman died on November 4, 1965 whereupon plaintiffs herein were duly appointed executors of his estate.) Jurisdiction is based upon diversity of citizenship. The complaint, *as amended by the Pre-Trial Order,* asserts that each of the three transactions enumerated above, to wit, the sale of Pathy's Series B AFR debentures to deMontmollin, the exchange of deMontmollin's AFR debentures for preferred stock,

and the discharge of deMontmollin's Burlington debentures and loan by her of $15,000 to AFR, constituted a breach of the subordination provisions. Relief is sought against the individual defendants, jointly and severally, in the amount of $64,000 with interest from June 1, 1957.

The issue confronting this Court, as framed in the Pre-Trial Order, is rather simply stated: "Did the individual defendants by their actions adn conduct breach the subordination provisions of the May 17, 1957 agreement [Buy-Sell Agreement] entered into by them with Samuel Buchman:" (PTO VIII(a).) It is to a closer look at each of the transactions in question that we now turn.[6]

The Sale Transaction

On June 1, 1957, Pathy sold his Series B AFR debentures to deMontmollin receiving $80,000 from her in payment thereof. Plaintiffs contend that this transfer of debentures constituted a breach of the subordination provisions of the Buy-Sell Agreement.

In an attempt to establish such breach, plaintiffs have endeavored to draw a distinction between the second and third paragraphs of subparagraph A of the SIXTH paragraph of the Buy-Sell Agreement. Plaintiffs argue that while the third paragraph covers only payments received from the corporations on the debentures, the second paragraph is not so restricted in terms of "source of

6. During the course of the trial, decision was reserved on a number of evidentiary rulings. We now proceed to dispose of them: individual defendants' motion to strike Exhibit 34 is denied; individual defendants' objections to Exhibits 39, 41 and 42 for identification are overruled and those exhibits are admitted in evidence; plaintiffs' motion to strike Exhibit ES is denied; plaintiffs' objections to Exhibits EV, EW, EX and EY for identification are sustained; plaintiffs' objection to Exhibit EZ for identification is overruled and that exhibit is admitted in evidence. Decision was also reserved on individual defendants' motion to dismiss made at the end of plaintiffs case. That motion is hereby denied.

payment." Relying on this presumed distinction, they contend that the proceeds of the sale should have been used to reduce the amounts owing on Buchman's debentures.[7]

This argument is rebutted by the unambiguous language of the subordination provisions themselves. The clear purport of those provisions was to prohibit the individual defendants from receiving any payment of principal or interest *from the corporations* on their debentures until Buchnan's debentures had been satisfied in full. Payment, upon sale and transfer of the debentures, from a source other than the corporations (here deMontmollin) was not prohibited by the provisions in question.

It is equally clear from the language employed that the possibility of future transfer of the debentures was recognized and permitted by the parties. The subordination provisions contemplated the possibility of holders of the debentures other than Pathy and deMontmollin and expressly provided for subordination of the debentures in the hands of "any holder."[8]

Pathy's sale of his Series B AFR debentures to deMontmollin did not breach the subordination provisions of the Buy-Sell Agreement; his debentures (now owned by

7. Plaintiffs' Memorandum Submitted At The Conclusion Of The Trial, p. 6.

8. The subordination provisions in part provided: ". . . Marie Louise deMontmollin and Alexander F. Pathy hereby agree with respect to the debentures of each of said corporations that the rights of any holder (including her or him) of the debentures thereof now held by her or him . . . ;" and

"[i]f for any reason, either corporation shall pay interest or principal on said debentures to any of the Buyers or to any person deriving title to the debentures of said corporation from any of the Buyers . . . " (Ex. 40.)

Individual defendants assert that "it is inconceivable that the parties would have written into the Agreement the phrase 'any holder (including her or him)' if the Agreement forbade there being any holder other than 'her or him.' " (Individual Defendants' Memorandum After Trial, p. 50). We fully agree.

deMontmollin) remained subordinated to the debentures held by Buchman.[9]

We recognize that the transfer of Pathy's debentures may have violated the terms of the Subordination Agreement (Exhibit EN-1) entered into between The Pennsylvania Company For Banking and Trusts (hereinafter the Pennsylvania Bank), AFR, and Buchman, Pathy and deMontmollin.[10] Breach, if any, of that agreement, however, is not the issue presently confronting us; the Pennsylvania Bank is not a party to the instant suit. Our concern rather is with an entirely separate agreement, the terms of which vary widely from those of Exhibit EN-1. Paragraph 9 of that exhibit, *supra* note 10, typifies language used where transfer of the subordinated debt is sought to be prohibited. The subordination provisions of the Buy-Sell Agreement, however, contain no similar prohibition on transfer; to the contrary, as previously discussed, they allow it.

The Exchange Transaction

In May 1958 and December 1959, deMontmollin surrendered debentures and promissory notes aggregating \$322,000[11] to AFR and received 3,220 shares of preferred

9. See Calligar, *Subordination Agreements*, 70 Yale L. J. 376, 399 (1961).

10. Paragraph 9 of that Agreement provided: "Creditors [Buchman, Pathy, and deMontmollin] agree that so long as there remains any Indebtedness of Borrower to Bank, Creditors will not assign or transfer any of Borrower's Indebtedness to Creditors or any instrument evidencing the same, and in the event of any such assignment or transfer the Creditor so assigning or transferring shall thereupon immediately become liable to Bank in the amount of the Indebtedness so assigned or transferred."

There is absolutely nothing in the Buy-Sell Agreement which even intimates that the parties intended to have this prohibition on transfer become a part of their agreement. Further, the two agreements were not co-extensive in duration.

11. Individual defendants' state that "[i]n and by the exchange, debts of the COMPANY aggregating \$300,000, owed to Mrs. deMontmollin, were

stock in exchange therefor. Did this conversion of subordinated debt into equity violate the subordination provisions of the Buy-Sell Agreement? Resolution of this novel issue requires an understanding of the nature and effect of the subordination provisions and of the relationship created by them between Buchman (the senior creditor)[12] and the individual defendants (the junior creditors).[13]

The subordination provisions had two principal effects. First, as already discussed, the individual defendants were expressly prohibited from receiving any payment of interest or principal from the corporations on their debentures until all of Buchman's debentures had been fully satisfied. *This prohibition ensured that the* corporations' assets *would not be reduced by payments on the subordinated debts until Buchman's debentures had been fully paid.* If any payments of interest or principal were received by the individual defendants before Buchman's debentures were fully satisfied, such amounts, by the terms of the subordination, were to be promptly paid to Buchman. This type of agreement, under the terms of which "no payment of

11 (Continued)
turned into equity investments. $231,000 of the $300,000 was represented by debentures which were subordinated to BUCHMAN'S debentures. $69,000 was represented by notes . . . " (Individual Defendants' Memorandum After Trial, p. 23.) While these figures are inaccurate (the debts of the corporation converted into preferred stock aggregated $322,000 (PTO 40); the subordinated debentures converted could not possibly have totaled $231,000 since, with the exclusion of deMontmollin's Burlington debentures which were not converted, the AFR debentures subordinated to Buchman's debentures only totaled $222,000), we feel safe in assuming that de Montmollin converted all of her Series A and B AFR debentures (inclusive of those she acquired from Pathy) which were subordinated to Buchman's debentures.

12. "Senior creditor" refers to the holder of the senior debt. "Junior creditor" refers to the subordinator or the holder of the subordinated debt.

13. Pathy held no subrodinated debentures at the time of the exchange. His Series B debentures which were sold to deMontmollin in June 1957 were exchanged by her for preferred stock.

principal or interest on the subordinated debt is permitted . . . so long as specifically identified senior debt remains unpaid," is commonly referred to as a "complete" subordination.[14]

Second, while subordination "suggests a mere ranking of priority, upon the insolvency of the common debtor the amounts otherwise payable on the junior creditors claim will in the usual subordination situation be payable to the senior creditor."[15] Thus, subordination has "the practical effect of making the subordinated debt a type of security for the senior debt, available to the senior creditor upon a distribution of the assets of the debtor."[16] Stated another way, the subordinated debt has a "collateral value" to the senior creditor in the event of the common debtor's insolvency which justifies his regarding it as a "cushion" or "support" for his senior debt.[17] Whether a junior creditor (here deMontmollin) could extinguish this so-called "security" or "cushion" without breaching the subordination provisions is an issue we reserve for later discussion.

Much of the trial record[18] concerns itself with the

14. Calligar, *supra* note 9, at 378. See also Coogan, Kripke, and Weiss, *The Outer Fringes of Article 9: Subordination Agreements, Security Interests In Money And Deposits, Negative Pledge Clauses, . And Participation Agreements,* 79 Harv. L. Rev. 229, 234 (1965); 2 Gilmore, Security Intersts in Personal Property §37.1 at 986 (1965).

15. Coogan, Kripke, and Weiss, *supra* note 14, at 236 n. 25.

16. Calligar, *supra* note 9, at 378.

17. Golin, *Debt Subordination As A Working Tool,* 7 N.Y.L. F. 370, 379 (1961); Everett, *Subordinated Debt-Nature, Objectives and Enforcement,* 44 Boston Univ. L. Rev. 487, 524 (1964); Coogan, Kripke and Weiss, *supra* note 236 n. 25. One commentator has stated that "[t]he [senior] creditor is advantaged by obtaining, either specifically for itself or generally with other creditors, a collateralized position and a resulting superior right of distribution to the debtor's assets." Golin, *supra* at 379. See also 2 Gilmore, *supra* note 14, §37.1 at 985-86.

18. Pathy was the only witness to testify at trial.

conflicting positions taken by the parties on the meaning of the word "payment" found in the subordination provisions. Plaintiffs, contending that "payment" means "the transfer of consideration which discharges a debt,"[19] argue that deMontmollin's receipt of preferred stock in exchange for her debentures constituted "payment" of those debentures. The individual defendants, on the other hand, assert that "payment," as used in the subordination provisions, contemplated only payment with assets of the corporation; since no assets of the corporation were expended in discharging the debentures, they argue no "payment" was received. *We agree with the position of the individual defendants.*

While the exchange resulted in the discharge of the debentures as legal obligations of the corporation, the receipt of preferred stock in place thereof did not constitute "payment" (of interest or principal) as that term was used in the subordination provisions.[20] The clear intent of those provisions was to prohibit any payment *out of the assets of the corporation* on the individual defendants' debentures before Buchman's debentures were paid in full. No assets of AFR were paid out in discharging deMontmollin's debentures. The exchange did not affect the asset side of the corporation's balance sheet; only the liabilities and capital side was affected, i.e. long-term debt was converted into capital.[21]

19. Plaintiffs' Memorandum Submitted At The Conclusion Of The Trial, p. 12.

Plaintiffs' place much reliance on the fact that Pathy understood the word "payment" — as used in the last resolution of Exhibit 33—to mean "legal discharge." (Tr. 171.) The meaning attributed to "payment" when used in a different context and outside of the subordination provisions, is not controlling. We note, however, that the indebtedness of the corporation was "legally discharged" in and by the exchange. As will be explained, this does not mean that "payment," as that was used in the subordination provisions, was received on the debentures.

20. *Cf. McConnell v. Estate of Butler*, 402 F.2d 362, 366 (9th Cir. 1968).

21. See EXs. EP and EQ.

In this Court's memorandum of May 9, 1967, denying individual defendants' first summary judgment motion,[22] we noted that the possibility that the exchange was "a first step in a plan to obtain cash—or cash realizable property—from the corporations" had not been excluded. In an effort to disprove the existence of such a plan, individual defendants sought to establish at trial that the prime objective of the exchange was to obtain a higher credit rating from Dunn & Bradstreet and other rating companies, and thereby increase the credit capacity and borrowing power of AFR. (Tr. 272-73.)

We need not determine whether the existence of such a plan (although never fully consummated) would constitute a breach of the subordination provisions since we are convinced that the exchange was not a first step in a plan by which the individual defendants, or any one of them, would obtain cash on its equivalent from the corporation. In fact, an examination of deMontmollin's status as a holder of preferred stock indicates that it was highly improbable that she would realize any cash or its equivalent out of the assets of AFR by means of the exchange.

The stock acquired through the exchange was five per cent (5%) cumulative preferred stock which was redeemable at any time by the corporation. (EX. EO.) As detailed below, AFR, however, was effectively precluded (at all times with which we are here concerned) from either paying dividends on, or redeeming any shares of, the preferred stock.

Each AFR Series B debenture provided for the payment of interest at the rate of five per cent (5%) per annum and for the payment on each interest payment date (commencing February 1, 1956) of five per cent (5%) of the

22. We denied individual defendants' second summary judgment motion on August 13, 1968.

respective principal amount thereof.[23] AFR agreed that "as long as any past due installments of principal remain unpaid it will not declare any dividends upon any class of its capital stock . . . . " (EX 37, ¶5.)

The corporation never paid any portion of the principal amount owing on Buchman's Series B debentures. (PTO 38.) In fact, until some time in 1959 when Walter E. Heller & Co. replaced the Pennsylvania Bank as the main source of financing for the corporation, AFR was prohibited by the terms of the Subordination Agreement with the Pennsylvania Bank[24] from making any payments on account of principal on its Series B debentures.[25] (EX. EN-1, P8). Accordingly, no dividends could be declared on the preferred stock since no installments of principal were paid on Buchman's Series B debentures.

Redemption of the preferred shares was prohibited by the very terms of the Buy-Sell Agreement:

> To induce the sale of capital stock hereunder, the Buyers warrant and agree that, until the entire purchase price hereunder shall have been paid in full and until all the debentures and the Promissory Note now held by Samuel Buchman (which are described in paragraph SIXTH hereof) shall have been paid in full, neither American Foam nor Burlington will redeem or purchase any of its capital stock or make any distribution to its stockholders in the nature of a liquidation or partial liquidation . . . . (EX. 40, EIGHTH paragraph.)

23. AFR was not "required to make any payment on account of principal if the undersigned has not accumulated earnings and profits at least sufficient in amount to provide for that payment." (EX. 37, ¶5).

24. The parties to the instant litigation were also parties to that subordination agreement under the terms of which they agreed to subordinate their Series B debentures to AFR's indebtedness to the Pennsylvania Bank. (EX. EN-1.) See also subparagraph C of the SIXTH paragraph of the Buy-Sell Agreement. (EX. 40.)

25. AFR was permitted to make payments of interest (not in excess of 5 % per annum) on the debenture bonds. (EX. EN-1, ¶12).

Additionally, while the Term Loan Agreement with the Pennsylvania Bank (Exhibit EN) remained in effect,[26] AFR had to refrain from purchasing or redeeming any of its capital stock or that of any of its subsidiaries "if the aggregate consideration for all of such purchases and redemptions exceeds $10,000 in money or property." (EX. EN, §4.11).

It is clear from the foregoing that AFR could not redeem or purchase any of the shares of preferred stock issued to deMontmollin in exchange for her debentures. Further, no dividend payments could be made on said shares unless and until all past due instalments of principal on the outstanding Series B debentures were paid. Under such circumstances, we cannot comprehend the exchange as a first step in a plan to obtain cash or its equivalent from AFR.

Dividends paid on subordinated debt

While the exchange transaction did not result in deMontmollin receiving "payment" (as that term was used in the subordination provisions) of interest or principal on her debentures, it did have the adverse affect of depriving Buchman, and now his executors (the plaintiffs herein), of a "double dividend"[27] out of AFR's bankrupt estate — i.e. the dividends paid on the senior debt and, by reason of the subordination provisions, the dividends paid on the subordinated debt. The following example illustrates why, from the point of view of the senior creditor, subordinated debt is preferable to equity:

26. Burlington was also a signatory to that agreement.

27. Calligar, *supra* note 9, at 377; 2 Gilmore, *supra* note 14, §37.1 at 985.

> [A]ssume that a bankrupt company has $600,000 of assets and has outstanding $500,000 of senior debt, $500,000 of subordinated debt, and $500,000 of other debt. On a distribution of all the assets of the company the senior debt would receive $400,000 — the $200,000 dividend paid on the senior debt plus the $200,000 dividend paid on the subordinated debt—and the other debt would receive $200,000. If the subordinated debt had been preferred stock, however, the senior debt would have received only $300,000, with the remaining $300,000 being paid on the other debt.[28]

Individual defendants are mistaken in arguing "[i]f nothing is paid out of assets it is of no consequence to the favored creditor that the subordinated debt is wiped out."[29] Buchman's "security" or "cushion" for his senior debt was lost when the subordinated debt was "wiped out." The exchange affected Buchman in the same way that a discharge of the subordinated debt by waiver, forgiveness, or cancellation would have, namely, he was deprived of the dividend—the junior creditor's (here deMontmollin's) dividend—on the subordinated debt.

Subordination agreements have long been upheld by the courts. In bankruptcy proceedings, the terms of subordination have been enforced with the result that the dividends paid on the subordinated debt are allocated to the senior debt.[30] This has been so despite the absence of any reference in the subordination agreements to bankruptcy proceedings.[31] Accordingly, had deMont-

28. Calligar, *supra* note 9, at 377.

29. Individual Defendants' Memorandum After Trial, p. 41.

30. Subordination Agreements have been enforced on a variety of theories. See 2 Coogan, Hogan, Vagts, Secured Transactions under U.C.C. §23. 02[3] at 2352 n. 21; Calligar, *supra* note 9, at 383-92.

31. See *In re Credit Industrial Corp.*, 366 F.2d 402, 412 (2d Cir. 1966). Cf. *In re Aktiebolaget Kreuger & Toll*, 96 F.2d 768, 770 (2d Cir. 1938).

mollin remained a creditor of AFR, the dividends paid out of the bankrupt estate on her subordinated claims would have been allocated to Buchman's senior debt.

DeMontmollin, however, did not retain her junior creditor status; rather, through the exchange she became a stockholder of AFR thereby subordinating her claim against the corporation to the claims of all creditors. The "security" of a "double dividend" in the event of bankruptcy was lost to Buchman.

Did deMontmollin breach the subordination provisions when she altered her status from one of junior creditor to that of preferred stockholder? Was she prohibited by the terms of the subordination from discharging the subordinated debt?

Individual defendants', citing no authority, vigorously contend that it is "preposterous" to believe that subordination forbids discharging ("wiping out") the subordinated debt.[32] We must disagree. The authority that exists, scant though it may be, points convincingly in the opposite direction.

In *In re Dodge-Freedman Poultry Co.*,[33] Freedman, the president, director, and principal stockholder of Dodge-Freedman Poultry Company, in consideration for credit extended by Delaware Mills to the Poultry Company, agreed to subordinate all of his claims against the Poultry Company (totaling $50,000) to the debt owed by the Poultry Company to Delaware Mills, and further agreed that no payments would be made to him until all amounts owing to Delaware Mills had been paid. In 1955 the Poultry Company filed a petition for an arrangement under

32. Individual Defendants' Reply Memorandum, p. 13.

33. 148 F. Supp. 647 (D.N.H. 1956), *aff'd sub nom.*, *Dodge-Freedman Poultry Co. v. Delaware Mills, Inc.*, 244 F.2d 314 (1st Cir. 1957).

Chapter XI of the Bankruptcy Act. A Plan of Arrangement was subsequently adopted providing for payment of a fifteen per cent (15%) dividend to all unsecured creditors in full satisfaction of their claims. One such unsecured claim was the $50,000 owing to Freedman; by the terms of the Arrangement, he was entitled to receive a dividend of $7,500 on his claim. Before payment, however, Freedman waived all rights to share in any dividend under the plan.[34]

Delaware Mills, having received a 15% dividend on its own claim, filed another proof of claim asserting its right to an additional dividend of $7,500 (the dividend Freedom would have received had he not waived his claim) by virtue of the subordination agreement.

The court, in upholding Delaware Mills' right to Freedman's dividend, made the following pertinent observations:

> The forbearance agreement prevented him [Freedman] from collecting and retaining any money on his own behalf so long as Delaware's claim had not been satisfied up to the agreed sum. As a result, it might seem that Freedman was actually fulfilling his contract when he waived all rights, because he was, in effect, forbearing. But equity will regard the substance rather than the form of every agreement and examine its purpose and intent. [citation omitted.] Applying this principle to the contract, it is obvious from its language that its intent and purpose was that Delaware's claim would be 'satisfied and paid.' Therefore, by looking behind the mere formality of forebearance, equity can take cognizance of the fact that Freedman, to a limited extent, undertook to assure payment of Delaware's claim up to $50,000. Although it is true that Freedman had no duties to perform other than to forbear, he is, at the very least, barred by the spirit of the agreement from taking any action that might prevent the satisfaction of Delaware's claim. By waiving his right to a dividend, Freedman is doing just that. He is returning the money to the debtor against whom Delaware Mills has no further rights since it has already accepted its full, legal share under the *Plan of Arrangement.* Thus Freedman was estopped from waiving his claim, for to do so violates the intent and purpose behind the agreement.[35]

The court went on to enforce the subordination agreement by holding Freedman to be a "constructive trustee" for Delaware Mills.

The facts of our own case are in some respects quite similar to those in *Dodge-Freedman.* Here we have a situation where a junior creditor, who was a principal stockholder, director and officer of the common debtor, through the expedient of the exchange transaction, discharged the subordinated debt. There apparently was no way for Buchman, at the time he entered into the Buy-Sell Agreement, to anticipate this happening. This is not a case where a senior creditor should have been cognizant of the consequences of debenture provisions allowing conversion of the subordinated debt into capital stock. AFR's Series A and B debentures contained no provisions permitting conversion (at the option of the holder) into capital stock.[36] Conversion became possible only after the individual defendants in their capacities as officers, directors and stockholders of AFR caused the certificate of in-

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34. The $50,000 claim was both proved and waived by Mrs. Freedman. For purposes of the proceeding, however, it was agreed to consider the claim filed and waived by her as being a claim of Freedman.

35. *In re Dodge-Freedman Poultry Co., supra* note 33, at 651.

36. We have not been informed of the provisions of AFR's Series A Debentures. We assume, from the silence of the parties, that they, like the Series B debentures contained no provision permitting conversion into capital stock.

corporation to be amended to provide for preferred stock, and thereafter passed the resolution allowing preferred shares to be issued in exchange for Series A and B debentures surrendered to the corporation. (EX. FD.)

We note that our problem presents an aspect which differs from that confronting the court in *Dodge-Freedman.* Here the subordinated debt was discharged considerably before the filing of AFR's voluntary petition for an arrangement under the Bankruptcy Act.[37] This distinction notwithstanding, we believe that the reasoning which estopped Freedman from waiving his dividend is fully applicable here.[38] It matters not that the subordinated debt was discharged before bankruptcy rather than after; the effect on the senior creditor, i.e. loss of the dividend on the subordinated debt, is identical in both cases.[39]

In *Cherno v. Dutch American Mercantile Corp.*,[40] Blanmill Realty Corp., in consideration for Dutch American loaning Itemlab, Inc., $50,000 on Itemlab's note in that amount, agreed that its claim against Itemlab for $87,000, evidenced by a note and secured by a chattel mortgage, " 'shall * * * be subject and subordinate in lien to the lien of said note for $50,000.' and that 'no part of the

37. The exchange of debentures for stock took place in May 1958 and December 1959. AFR filed a voluntary petition under Chapter XI of the Bankruptcy Act on January 17, 1961. The Corporation was adjudged a bankrupt in February, 1961.

38. While relying on that portion of the court's reasoning previously set out in the body of this opinion, we recognize the inapplicability of the constructive trust theory to the facts of this case. See *Cherno v. Dutch American Mercantile Corp.*, 353 F.2d 147, 154 (2d Cir. 1965).

39. "In light of the attempt made by the subordinator in *Dodge-Freedman* to escape the consequences of his subordination," one commentator has suggested that "it might be well to insert in future subordination agreements a provision prohibiting waiver, forgiveness, or cancellation of the subordinated debt." Calligar, *supra* note 9, at 387-88.

40. 353 F.2d 147 (2d Cir. 1965).

indebtedness * * * shall be paid [to Blanmill] until all sums due and owing to Dutch American Mercantile Corp. shall have been paid and disposed of. ' "[41]

Itemlab defaulted on its note to Dutch American, and the latter commenced an action to recover the amount due. While that case was pending, Blanmill "executed and filed a satisfaction on the chattel mortgage in spite of the fact that no part of the mortgage debt had ever been paid."[42] An innocent third party, relying on such discharge, thereafter loaned funds to Itemlab on the security on the same chattels. Upon Itemlab's bankruptcy the chattels were sold and Dutch American claimed the proceeds of the sale. The court denied Dutch American's claim to the proceeds holding that the subordination agreement did not result in an equitable assignment of the subordinated debt on the chattel mortgage.[43] The court also rejected the assertion that an equitable lien on, or constructive trust of,[44] the chattels or their proceeds resulted from the subordination.

The importance of this case for present purposes arises from the following statement by the court:

> Dutch American at no time had an interest in or lien upon the chattels. Its so-called "security" was nothing more than a promise by Blanmill to apply no payment against the mortgage debt until Dutch

41. 353 F.2d at 149.

42. *Id.*

43. The court further held that even if an assignment did result, the law of New York required that it be recorded to be effective against third parties.

44. While the court rejected Dutch American's claim to the proceeds of the chattels, it did hod that "if, at the conclusion of the bankruptcy proceedings in Itemlab, Inc., debtor, liquidation had been accomplished and a distributive dividend were ordered to Blanmill and Dutch American, as creditors, Dutch American, on the theory of constructive trust, could, to the extent of its claim, receive Blanmill's dividend under the subordination agreement and prevent Blanmill from taking it and using it for its own purposes." 353 F.2d at 154.

> American was paid in full. *Blanmill breached that agreement,* but breach of a contract concerning payment of a debt furnishes no basis for the finding of a constructive trust. [citation omitted.] Dutch American could enforce the obligation against Blanmill and Itemlab as parties to the subordination agreement but not against other existing or subsequent creditors. (Emphasis supplied.)[45]

The court's statement that Blanmill breached the subordination agreement could only have reference to its discharge of the chattel mortgage.[46] We interpret the court as saying that the junior creditor's discharge of the chattel mortgage securing the subordinated debt constituted a breach of the subordination agreement.[47] If this is so, and we have no reason to doubt that it is, then discharge of the subordinated debt itself most certainly constitutes a breach of the subordination.

The foregoing authorities convince us that deMontmollin's discharge of her Series A and B AFR debentures

45. 353 F.2d at 154.

46. No part of the debt which the mortgage was intended to secure was paid.

47. It is significant to note that in the converse situation, i.e. release by a senior creditor of collateral security held for the senior debt, the junior creditor would be adversely affected.

> "To the extent that such collateral is not available to the senior creditor in the event of the bankruptcy of the debtor, dividends on the subordinated debt must be used in making the senior creditor whole. In other words, by giving up his collateral, the senior creditor makes it more likely that if the debtor goes bankrupt, the senior creditor will have to satisfy the obligation owed him by taking the junior creditor's dividends. It would therefore follow, in the absence of a provision permitting the senior creditor to alter the terms of the debt or deal with the security therefor that the senior creditor might be obliged to some extent to the subordinating creditor as to the value of the collateral released." Calligar, *supra* note 9, at 530-31.

Professor Gilmore has stated: "No doubt release or impairment of collateral by a secured senior should pro tanto release the unsecured subordinator from his duties under the subordination agreement just as it would release a surety." 2 Gilmore, *supra* note 14, § 37.1 at 985-86 n. 10.

by means of their exchange for preferred stock constituted a breach of the subordination provisions of the Buy-Sell Agreement. Buchman's contemplated right to the dividend which would have been paid on the subordinated debt, had it not been discharged, was lost by virtue of the exchange. The absence of any express reference in the subordination provisions to either distributive dividends on bankruptcy is not controlling.[48] Implicit in the language used is the intent of the parties that Buchman have the "security"[49] of the subordinated debt in the event of the common debtor's bankruptcy. This "security" was lost to Buchman just as it was lost to Dutch American in *Cherno*[50] and almost lost to Dellaware Mills in *Dodge-Freedman.* At the very least, deMontmollin was barred by the terms of the subordination from taking any action that might prevent satisfaction of Buchman's claim.[51] Her exchange of debentures for preferred stock had just that effect.

Leading commentators have devoted considerable energy to the question: "Does a subordination create an article 9 security interest against the junior creditor and in favor of the senior creditor?"[52] The answer to this question becomes important in situations where both the common debtor and the junior creditor have gone bankrupt[53] since there the issue of priority between the senior creditor and

48. See cases cited in note 31, *supra.*

49. The "security" that comes from the senior creditor's right to the distributive dividend paid on the subordinated debt.

50. Dutch American did not lose all its "security" since Blanmill still held Itemlab's note for $87,000. See note 44, *supra.*

51. A subordinator has been referred to as "a guarantor to the extent of the value of the subordinated debt." Calligar, *supra* note 9, at 394. But see Golin, *supra* note 17, at 371, where issue is taken with this characterization.

52. Coogan, Kriphe and Weiss, *supra* note 14, at 236. See also 2 Coogan, Hogan, Vagts, *supra* note 30, ch. 23; 2 Gilmore, *supra* note 14, §37.3 at 994.

53. See *Pioneer-Cafeteria Feeds, Ltd. v. Mack,* 340 F. 2d 719 (6th Cir. 1965).

the junior creditor's trustee in bankruptcy is a very real one.[54] We are not here faced with such a dilemma (plaintiffs seek only to recover against a junior creditor for her breach of the subordination provisions of the Buy-Sell Agreement), and accordingly intimate no view on the "true nature" of the interest created, if any, in favor of a senior creditor by virtue of a subordination agreement. We hold only that where a subordination agreement is in effect, in the absence of provisions to the contrary, it is a breach of that agreement for a junior creditor to discharge the subordinated debt as was done here.

The Loan Transaction

On April 1, 1960, deMontmollin's Burlington debentures aggregating $15,000 became due and payable. At some point (apparently in April) she surrendered these debentures to Burlington and received a credit for $15,000 on Burlington's Books. (Tr. 24.)[55] De Montmollin then proceeded to loan this same $15,000 to AFR and received a note[56] from AFR in that amount.[57]

54. If the senior creditor has acquired a security interest, and it does not meet the enforcement and perfection requirements of Article 9 of the Uniform Commercial Code, "it is not good against the junior creditor's trustee in bankruptcy. Coogan, Kripke, and Weiss, *supra* note 14, at 235.

55. DeMontmollin could draw against those funds from the time of credit to her account. (Tr. 26.)

56. Exhibit 36 states: "The loans [including de Montmollin's] are represented by 6 % notes maturing on December 30, 1960. Interest thereon has been paid through December 31, 1960."

57. Pathy described the transaction in question as follows:

> "[I]n April of 1960, Mrs. deMontmollin, who was supposed to receive $15,000 on her A bond Burlington debentures did not receive $15,000 on those bonds, but loaned those $15,000 to AFR." (Tr. 161.)
>
> "She had Burlington Holding bonds or debentures which matured in April of 1960. By that time Burlington was a subsidiary of American Foam. The same amount of $150,000 [sic] which were [sic] supposed to be paid to her but were [sic] not paid, were [sic] loaned by her to AFR and therefore it became a loan of an officer to AFR." (Tr. 173)

This series of "bookkeeping entries" had four principal effects: first, deMontmollin's Burlington debentures were discharged;[58] second, the assets of Burlington were reduced by $15,000 — the amount loaned by deMontmollin to AFR;[59] third, the assets of AFR were increased by $15,000; and fourth, deMontmollin became a note holder of AFR for the amount of the loan.[60] Viewed with these effects in mind, it becomes apparent that the loan transaction resulted in deMontmollin receiving "payment" on her Burlington debentures.

While deMontmollin did not "physically" receive cash (or its equivalent) from Burlington, she did receive a credit on Burlington's books for $15,000 which amount she then chose to loan to AFR. Certainly the fact that the funds did not "physically" pass through her hands on their way to AFR is not controlling. The effects of the transaction would have been exactly the same had she had Burlington pay her the $15,000 before she loaned it to AFR.

Clearly deMontmollin cannot get around the subordination provisions' prohibition on "payment" of her debentures by the series of "bookkeeping entries" involved here.[61] Her realization of "payment" in the amount of

58. The debentures ceased to be obligations of the corporation and the principal amount owing on them was credited to deMontmollin's account on Burlington's books. Burlington still owed deMontmollin $15,000 (evidenced by the credit to her account) but not by virtue of the debentures.

59. It is undisputed that the $15,000 loaned to AFR was the same $15,000 payable on the Burlington debentures. The $15,000 credit to deMontmollin's account must have been extinguished by her loan of those funds to AFR. This debit to her account must have been accompanied by a corresponding credit to Burlington's cash account.

60. Counsel for individual defendants, during the course of the trial, stated that "the $15,000 note which was taken by Mrs. deMontmollin in April 1960 and which was assigned to an attorney, and that is a claim in the bankruptcy proceeding." (Tr. 50.)

61. We cannot accept Pathy's oversimplified characterization of the transaction as simply a "bookkeeping device by virtue of which the indebtedness of the subsidiary [Burlington] became the indebtedness of the parent Co. [AFR]" without any amount being paid to deMontmollin. (Tr. 173, and 257.)

$15,000 on her Burlington debentures is attested to by the fact that she loaned these very funds to AFR.[62]

We hold that the loan transaction resulted in deMontmollin receiving "payment" of $15,000 on her Burlington debentures. By the terms of the subordination, she was required to promptly pay that amount over to Buchman. In failing to do so, she breached the subordination provisions of the Buy-Sell Agreement.

Damages

Before turning to the matter of damages, one preliminary point warrants attention. Plaintiffs seek to recover against the individual defendants "jointly and severally." No reason is assigned, however, why breach of the agreement by any one of the individual defendants should result in liability being imposed "jointly" on all of them. There is nothing in the Buy-Sell Agreement indicating that the individual defendants agreed to be "jointly" responsible for any breach of the subordination provisions.[63] It appears not to have been their intent to enter into a joint agreement with respect to subordination. Rather, each agreed to subordinate his or her own debentures to those debentures held by Buchman. The agreement was several not joint.

There is nothing before us to warrant the imposition of liability on Suzanne M. Pathy and Alexander F. Pathy. The former was not herself a subordinator, and the latter,

62. We intimate no view on whether the credit to her account standing alone, i.e. unaccompanied by the loan to AFR, constituted the receipt of "payment" resulting in the amount credited having to be paid to Buchman.

63. Contrast subparagraph F of the THIRD paragraph of the Buy-Sell Agreement where Pathy expressly agreed to guarantee the obligations thereunder of Suzanne M. Pathy.

while a holder of subordinated debt,[64] never breached the subordination provisions.[65] Only deMontmollin breached those provisions—only to the extent hereinabove discussed—and, accordingly, only she is liable to plaintiffs for the damages sustained by Buchman.

Both the exchange and loan transactions have been found to breach the subordination provisions of the Buy-Sell Agreement; the amount of damages resulting therefrom is the only issue remaining for determination.

Plaintiffs, without any specificity or breakdown of any sort, assert that they are entitled to $64,000 with interest from June 1, 1957. Individual defendants, on the other hand, contend that even if the subordination provisions were breached, "Buchman suffered no damage therefrom."[66] Both are wrong.

Buchman was certainly damaged when deMontmollin, in breach of the subordination provisions, failed to turn over the $15,000 she realized on her Burlington debentures. Accordingly, plaintiffs are entitled to recover that amount plus interest thereon from the date of such breach.

The damage resulting from deMontmollin's exchange of her AFR debentures for preferred stock is not as readily ascertainable. We have already seen that the exchange adversely affected Buchman by depriving him of the distributive dividends that would otherwise have been paid on the subordinated debts. Had deMontmollin remained a

64. We have already held that Pathy's transfer of his Series B AFR debentures to deMontmollin was not in breach of the subordination provisions.

65. The fact that both the Pathys were officers and directors of AFR, and, as such, had a hand in passing the resolution allowing the exchange of debentures for stock is far from decisive. It was only deMontmollin who exchanged her debentures for stock and thereby extinguished the subordinated debt.

66. Individual Defendants' Memorandum After Trial, p. 65.

junior creditor of AFR, the dividends paid out of the bankrupt estate on her subordinated claims would have been allocated to Buchman's senior debt. Plaintiffs, therefore, are entitled to the amount of such dividends lost to Buchman as a result of the exchange; that is, the amount of the dividends deMontmollin would have been entitled to out of AFR's bankrupt estate had she not converted her debentures into stock.

Plaintiffs, unfortunately, have failed to furnish this Court with sufficient information upon which to predicate a computation of deMontmollin's distributive dividends.[67] Therefore, we are faced with this additional challenge: Should we dismiss the claim because of a failure of proof in respect of damages (the trial record now being closed) or should we attempt to secure further information upon which damages may be predicated. We have decided to adopt the latter course.

Accordingly, the question still to be resolved is as follows: Assuming deMontmollin presently held the Series A and Series B AFR debentures she converted into preferred stock, what would be the total amount of dividends thereon that she would receive out of the bankrupt estate? In order to satisfactorily respond to this question, which we regard as expressing the formula upon which damages are to be predicated, the parties are allowed fifteen (15) days from the date of this Opinion to serve and file proof in affidavit form addressed to this sole remaining issue. We hereby request the Trustee in Bankruptcy (to whom a copy of this Opinion on its filing date will be mailed) to aid the parties in their efforts to resolve this question.

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67. Exhibit 39 does reveal that the assets in the hands of the Trustee amount to $91,179.35 while the total general claims aggregate $2,011,318.21.

As to liability only, the foregoing shall constitute this Court's Findings of Fact and Conclusions of Law.

New York, N.Y.
July 23, 1969

IRVING BEN COOPER
United States District Judge

APPENDIX C

ORDER DATED APRIL 12, 1976

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the fifth day of February, one thousand nine hundred and seventy-six.

Present:
HON. J. EDWARD LUMBARD
HON. WILLIAM H. MULLIGAN
HON. ELLSWORTH A. VAN GRAAFEILAND
Circuit Judges,

(SAME TITLE)

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order and judgment of said District Court be and they hereby are affirmed in part and reversed in part with costs to be taxed against the appellees in accordance with the opinion of this court.

A. DANIEL FUSARO
Clerk

By Vincent A. Carlin
Chief Deputy Clerk

Docketed as a Judgment
#76,317
on April 12, 1976

APPENDIX D

AMENDED ORDER AND JUDGMENT

(SAME TITLE)

A judgment #74,988, having been entered by this Court on December 20, 1974 granting the motion for summary judgment of plaintiff, DOROTHY BUCHMAN, as Executrix of the Estate of Samuel Buchman, deceased, and awarding her damages against the defendant MARIE LOUISE deMONTMOLLIN in the amount of $40,868.58; and

Defendants, having, by a Notice of Appeal filed with this Court the 9th day of January, 1975, appealed that judgment to the United States Court of Appeals for the Second Circuit; and

The United States Court of Appeals, in and by its judgment dated February 5, 1976 which judgment was filed in this Court on April 12, 1976, reversed that part of this Court's judgment contained in the second decretal paragraph by which plaintiff was awarded the sum of $11,514 plus interest in the amount of $338.58 and affirmed that part of this Court's judgment contained in the first decretal paragraph by which plaintiff was awarded the sum of $15,000 plus interest in the amount of $14,166, it is

ORDERED, ADJUDGED and DECREED, that the plaintiff, DOROTHY BUCHMAN, as Executrix of the Estate of Samuel Buchman, deceased, receive of the defendant, MARIE LOUISE deMONTMOLLIN, the sum of $15,000 with interest at the following rate per annum from the following dates:

(a) 6% per annum from April 1, 1960 to June 30, 1968;

(b) 7¼% per annum from July 1, 1968 to Feb. 15, 1969;

(c) 7½% per annum from February 16, 1969 to August 31, 1972;

(d) 6% per annum from September 1, 1972 to November 21, 1974;

(e) 6% per annum from November 21, 1974 to June 1, 1976.

The interest computed by the judgment clerk, following the formula above, shall be added to the $15,000 judgment of the Second Circuit and will constitute the total amount to be received by plaintiff, DOROTHY BUCHMAN, as Executrix of the Estate of Samuel Buchman, deceased, from the defendant MARIE LOUISE deMONTMOLLIN. (See *First National Bank of Hollywood, et. al v. American Foam Rubber Corp.*, Judgment #76,317 (2d Cir., April 12, 1976); *Id.*, Judgment #74,988, (S.D.N.Y. Dec. 19, 1974).)

Dated: June 1, 1976
New York, N.Y.

IRVING BEN COOPER
United States District Judge

Raymond F. Bugland
Clerk

APPENDIX E

AGREEment made this 17th day of May, 1957, between SAMUEL BUCHMAN and A. SANDER BUCHMAN, both of whom are sometimes referred to herein as "the Sellers," and MARIE LOUISE de MONTMOLLIN, SUZANNE M. PATHY and ALEXANDER F. PATHY, all three of whom are sometimes referred to herein as "the Buyers."

The Sellers desire to sell to the Buyers all of his capital stock of Burlington Holding Corp., a New York corporation, (sometimes referred to herein as "Burlington"), and the Buyers desire to buy the said capital stock of said two corporations from the respective Sellers.

In consideration of the premises, the parties hereto, for themselves and their respective executors, administrators, heirs and assigns, agree as follows:

FIRST: *Sellers' Warranties and Agreements to Sell*

A. Samuel Buchman represents and warrants that (1) he is the owner of 12,772 shares of the Class A capital stock of American Foam and 30 shares of the capital stock of Burlington, and (2) said shares constitute all the shares of capital stock issued by said two respective corporations, which are owned by him.

B. A. Sander Buchman represents and warrants that (1) he is the owner of 5,550 shares of the Class A capital stock of American Foam, and (2) said shares constitute all the shares of capital stock issued by said corporation which are owned by him.

C. Each of the Sellers represents and warrants that the said shares of the capital stock so owned by him are owned and held free and clear of all liens, encumbrances and restrictions, excepting such restrictions, if any, which may

be imposed by reason of (1) any agreement to which he and the Buyers, or any of the Buyers, are parties and (2) the bylaws of either of said two corporations.

D. Each of the Sellers shall sell to the Buyers the shares of capital stock of American Foam and Burlington owned by him and described above in this paragraph FIRST, on the terms and conditions herein stated.

SECOND: *Buyers' Agreement to Purchase*

The Buyers shall severally purchase from the Sellers, in the following respective amounts, the shares of capital stock of American Foam and Burlington owned by the respective Sellers and described in paragraph FIRST hereof, on the terms and conditions herein stated:

Buyer	*Shares of American Foam*	*Shares of Burlington*
Marie Louise de Montmollin	9,161	15
Suzanne M. Pathy	6,871	13
Alexander F. Pathy	2,290	2
Totals	18,322	30

THIRD: *Purchase Price*

A. The purchase price of the capital stock of American Foam to be sold and purchased under this agreement shall be Ten ($10) Dollars per share.

B. The purchase price of the 30 shares of capital stock of Burlington to be sold and purchased under this agreement shall be $40,000.

C. The purchase price shall be payable by the several Buyers to the respective Sellers, as follows:

Cash Payable at Closing *To Samuel* *To A. Sander*

	Buchman	Buchman
Marie Louise de Montmollin	$22,427.50	$7,572.50
Suzanne M. Pathy	$17,403.96	$5,679.38
Alexander F. Pathy	$ 5,023.54	$1,893.12
Totals	$44,855.00	15,145.00

Four (4) installments, each in the following respective amounts, payable successively January 2, 1958, April 2, 1958, July 2, 1958 and October 2, 1958

Marie Louise de Montmollin	$11,838.75	$3,786.25
Suzanne M. Pathy	9,243.75	$3,839.69
Alexander F. Pathy	2,595.00	946.56
Totals	$23,677.50	$7,572.50

Final installment payable January 2, 1959

Marie Louise de Montmollin	$14,078.83	$5,031.17
Suzanne M. Pathy	10,850.87	$3,773.38
Alexander F. Pathy	3,227.96	$1,257.79
Totals	$28,157.66	$10,062.34

D. EAch of the Buyers' obligations to pay his or her portion of each of the unpaid five installments of the purchase price shall be evidenced by a promissory note of a series, a copy of which is annexed hereto as Schedule A.

E. The promissory notes of the several Buyers shall be delivered to the respective Sellers at the closing. Such delivery shall not be deemed payment of the purchase price, it being the intention of the parties that payment for the shares of capital stock to be sold hereunder shall be

deemed made only when all of said notes, together with interest thereon, have been paid in full in cash.

F. The obligations of Suzanne M. Pathy hereunder shall be deemed guaranteed by Alexander F. Pathy, who waives notice of any modification, extension, presentment or dishonor of any of her promissory notes hereunder, and waives notice of the modification or extension of any of her obligations under this agreement.

FOURTH: *Closing*

The closing of such sale and purchase shall take place at the office of American Foam, 350 Fifth Avenue, New York 1, N.Y., at four o'clock in the afternoon on May 17, 1957. At the closing, each Seller shall deliver in negotiable form, the certificates of shares of capital stock of the Corporations to be sold by him hereunder and shall pay the cost of the documentary stamps required to be applied to his certificates of capital stock sold hereunder.

FIFTH: *Warranty of Validity of Agreement*

American Foam is entering into an agreement with Samuel Buchman, bearing even date herewith, covering, among other things, the termination of the employment of Samuel Buchman by said corporation. To induce Samuel Buchman to sell the capital stock hereunder, the Buyers hereby warrant that said agreement is valid and that the obligations imposed thereunder upon said corporation are binding upon it.

SIXTH: *Subordination*

A. The parties named below hold five (5%) percent registered debentures issued by American Foam or Burlington in the following respective amounts:

Name of Holder	American Foam Series A Debenture Due May 1, 1960	American Foam Series B Debenture Due May 1, 1965	Burlington Debenture Due April 1, 1960
Samuel Buchman	$48,000	$64,000	$12,000
Marie Louise de Montmollin	79,000	15,000	63,000
Alexander F. Pathy	-0-	80,000	-0-

To induce Samuel Buchman to sell his capital stock hereunder, Marie Louise de Montmollin and Alexander F. Pathy hereby agree with respect to the debentures of each of said corporations that the rights of any holder (including her or him) of the debentures thereof now held by her or him and referred to above, shall in all respects be subordinated to the rights of any holder or holders of the debentures thereof now held by Samuel Buchman (including him) as to the payment of interest and principal ~~and as to any other rights under said respective debentures.~~ No claim for interest under the debentures so subordianted shall be made unless all interest payable on the debentures now held by Samuel Buchman shall have been paid in full, and no claim for principal under any of the debentures so subordinated shall be made unless the entire principal of all the debentures now held by Samuel Buchman shall have been paid in full.

If for any reason, either corporation shall pay interest or principal on said debentures to any of the Buyers, or to any person deriving title to the debentures of said corporation

from any of the Buyers, and said payment shall be made without first satisfying the priority to which the holder or holders of Samuel Buchman's debentures are entitled by reason of the foregoing provisions, the amount or amounts of the payment so made by the Buyer (or to the person deriving title from her or him) shall be promptly paid by such Buyer to said holder or holders of Samuel Buchman's debentures. Any payment made on account of principal shall be endorsed on said debentures, which shall be submitted to the payor for that purposes.

B. Samuel Buchman is the holder of a five (5%) percent Promissory Note of American Foam in the sum of $25,000. The Buyers hold similar Promissory notes aggregating $100,000. To induce Samuel Buchman to sell his capital stock hereunder, the Buyers hereby agree to subordinate the payment of (1) interest of their respective said Promissory Notes to the payment of interest and (2) principal thereof to the payment of principal, on or of said $25,000 Promissory Note held by Samuel Buchman and they further agree to make no claim for interest on their respective said Promissory Notes until interest on the Promissory Note held by Samuel Buchman shall have been paid in full, and to make no claim for principal unless the principal of the Promissory Note held by Samuel Buchman shall have been paid in full.

C. To induce the respective Buyers to buy his capital stock sold hereunder, Samuel Buchman hereby agrees with respect to his debentures of American Foam and Burlington that the rights of any holder (including him) of said debentures shall in all respects continue to be subordinated, as they are presently, to claims of The First Pennsylvania Banking and Trust Company now existing against said corporations or either of them by reason of credit extended, or to claims of any other financial in-

stitution which after the date hereof may in whole or in part become a creditor of said corporations or either of them by reason of the refinancing of the credit now extended to said corporations or either of them by The First Pennsylvania Banking and Trust Company. Samuel Buchman's agreement so to continue the subordination of his debentures shall be subject to the two following limitations: (1) Such agreement shall expire on December 31, 1959, and (2) the aggregate indebtedness of either or both of said corporations to which his debentures shall continue to be subordinated, as above provided, shall not be in excess of $650,000.

SEVENTH: *Security*

To secure the Sellers in the payment of the notes described in paragraph THIRD hereof, the Buyers shall at the closing, following the reissuance to them of the shares of stock sold to them hereunder, endorse their respective certificates in blank and deliver the same to the Escrow Agent hereunder to be held by him as collateral security for the payment of said notes. Voting rights on said shares shall remain with the Buyers, but any distribution thereon shall also be retained as collateral security.

In the event that the Escrow Agent shall be notified that any Buyer shall have defaulted in the payment of any of the notes given by him or her hereunder and that such default has continued for five days, the Escrow Agent shall, if satisfied that such default has occurred, be vested with authority to sell the shares represented by the certificates so deposited in escrow by the defaulting Buyer, or any of said shares, at public sale, and the Sellers, or either of them, shall have authority to bid and/or purchase at any such sale, with the right of becoming the absolute owner of the same, free of all trusts, claims and equity of redemption. On any sale of such shares, the proceeds thereof, shall be

first applied to pay and discharge the unpaid obligations of such Buyer plus the expenses of the sale, and the overplus, if any, shall be paid to such Buyer; and if such proceeds shall be insufficient to pay and discharge said unpaid obligations and expenses, the Buyer shall remain liable for the difference.

After payment of the entire purchase price shall have been made by any Buyer, the Escrow Agent, upon demand, shall deliver to such Buyer the certificates represented by such Buyer's shares held in escrow. Before delivery, the Escrow Agent shall have a reasonable time to satisfy himself that such payment has been made.

In the absence of gross negligence or bad faith, the Escrow Agent shall not be liable to any person for any act or omission to act on his part, with respect to the collateral so deposited with him. Before taking any action, he may require that he be reimbursed for his reasonable expenses, including the expense of retaining counsel.

EIGHTH: *Buyers' Warranties*

A. To induce the sale of capital stock hereunder, the Buyers warrant and agree that, until the entire purchase price hereunder shall have been paid in full and until all the debentures and the Promissory Note now held by Samuel Buchman (which are described in paragraph SIXTH Hereof) shall have been paid in full, neither American Foam nor Burlington will redeem or purchase any of its capital stock or make any distribution to its stockholders in the nature of a liquidation or partial liquidation, excepting, however, the discharge by American Foam of its existing contingent obligation to repurchase capital stock acquired by Felix A. Buskey or William M. Barstow, Jr., under stock options now existing.

B. To induce Samuel Buchman to enter into the agreement with American Foam bearing even date

herewith, covering, among other things, the termination of his employment by said corporation, the Buyers warrant and agree that they will not collect or receive any further compensation from American Foam until Buchman shall have been paid the sum of $19,650, which said corporation is obligated to pay him as compensation under said agreement no later than October 15, 1957.

NINTH: *Resignations*

Samuel Buchman shall resign forthwith as director and officer of American Foam, it subsidiaries, and Burlington, and shall deliver to said respective corporations all and any records, samples or other property belonging to said respective corporations, which he may have now in his possession.

TENTH: *Notices*

Any and all notices, consents, requests or other communications hereunder shall be given in writing by registered or certified mail. Any such writing to be given to any of the Buyers may be addressed to him or her c/o Alexander F. Pathy, Esq., 60 East 42nd Street, New York 17, N.Y. Any such writing to be given to either Seller may be addressed to him at 2201 Parkway, Philadelphia 30, Pennsylvania. Such address of any party may be changed by him or her by written notification under this paragraph, provided that the changed address is one within the United States of America.

ELEVENTH: *Modification*

No change or modification of this agreement or any of its provisions shall be binding on any party hereto unless the same shall be in writing and signed by such party.

TWELFTH: *Applicable Law*

The provisions of this agreement, and the performance thereunder, shall in all respects be construed and enforced

in accordance with the laws of the State of New York.

THIRTEENTH: *Captions*

The captions of the respective paragraphs hereunder are inserted for convenience only and are not to be used in construing any of the provisions.

IN WITNESS WHEREOF, the parties hereto have executed this agreement on the day and year first above written.

s/Samuel Buchman
SAMUEL BUCHMAN

s/A. Sander Buchman
A. SANDER BUCHMAN

s/Marie Louise de Montmollin
MARIE LOUISE DE MONTMOLLIN

s/Suzanne M. Pathy
SUZANNE M. PATHY

s/Alexander F. Pathy
ALEXANDER F. PATHY

In The

SUPREME COURT OF THE UNITED STATES

No. 76-41

FIRST NATIONAL BANK OF HOLLYWOOD, DOROTHY BUCHMAN and SANDER BUCHMAN, as Executors of SAMUEL BUCHMAN, Deceased.

Petitioners,

-against-

AMERICAN FOAM RUBBER CORP., MILTON R. ACKMAN, as Trustee of American Foam Rubber Corp., Bankrupt,

Defendants,

MARIE LOUISE de MONTMOLLIN, ALEXANDER F. PATHY and SUZANNE M. PATHY,

Defendants-Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION [redacted]

DAVID SIVE
WINER, NEUBURGER & SIVE
Attorneys for Defendants-Respondents
425 Park Avenue
New York, New York, 10022

In The

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1976

No.

FIRST NATIONAL BANK OF HOLLYWOOD, DOROTHY BUCHMAN and SANDER BUCHMAN, as Executors of SAMUEL BUCHMAN, Deceased,

Petitioners,

-against-

AMERICAN FOAM RUBBER CORP., MILTON R. ACKMAN, as Trustee of AMERICAN FOAM RUBBER CORP., Bankrupt,

Defendants,

MARIE LOUISE de MONTMOLLIN, ALEXANDER F. PATHY and SUZANNE M. PATHY,

Defendants-Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION AND CONDITIONAL CROSS-PETITION FOR WRIT OF CERTIORARI

Defendants-Respondents, MARIE LOUISE de MONTMOLLIN, et al. ("defendants") oppose the granting of the petition for certiorari for the reasons stated briefly below. In the alternative, and in the event that the petition of plaintiff is granted, defendants respectfully cross-petition for a writ of certiorari to review the portion of the order of the court below dealing with "The Loan Transaction". As authority for such cross-petition, defendants respectfully refer to Pierson v. Ray, cert. granted, 384 U.S. 938, decided on merits, 386 U.S. 547 (unreported chronology discussed in 1 West's Federal Forms §280 (1969)).

The Petition Was Not Timely Filed

On March 26, 1976 the court below denied motions to reargue. The time to file a petition for certiorari expired on the ninetieth day thereafter, June 24, 1976. The petition herein was filed on or about July 13, 1976. For that reason alone it must be denied.

The Petition Is Without Merit

Rule 19 of the Supreme Court Rules provides that:

> 1. A review on writ of certiorari is not a matter of right, but of sound judicial discretion, and will be granted only where there are special and important reasons therefor.

The first four of plaintiff's "Reasons For Granting Writ" require no extended answer. It is probably correct that "[t]he legal issue in this case is one of first impression", but that is no ground for granting the writ. The second, third and fourth reasons are hardly more than chatter, more appropriate for a business column in a newspaper than for a petition for certiorari.

The fifth reason is the alleged conflict among circuits. It is purportedly based upon reported cases. Typical of the cases cited is Bank of America Nat'l Trust

& Sav. Ass'n v. Erickson, 117 F.2d 796 (9th Cir. 1941). It is not "in conflict with" the decision plaintiffs request this Court to review. It is one of dozens of decisions upholding the power of a bankruptcy court to subordinate claims on legal or equitable grounds. None of the other cases cited poses any conflict.

The decision below is not in conflict with "the commercial and historical development of the subordination agreements and judicial holdings." On the contrary, if a pattern can be traced, it is one calling for writers of subordination agreements to state the rights and duties of the parties with increasing care and particularity and not to foist upon courts the obligation to write in additional provisions. As the court below, after referring to "the remote chance that bankruptcy might someday occur and the senior creditor might

thereafter be deprived of a double dividend", stated:

> We think that if the senior creditor would prohibit a discharge because of such remote contingencies, he should so provide in the subordination agreement.

Conditional Cross-Petition For
Writ of Certiorari To The United
States Court Of Appeals For The
Second Circuit

Defendants petition for a writ of certiorari to review "The Loan Transaction" portion of the judgment of the United States Court of Appeals for the Second Circuit, the writ to issue, however, only in the event that this Court grants the petition for writ of certiorari in No.   , this Term.

Question Presented

Whether the court below erred in holding that the loan transaction was not a

series of bookkeeping entries between parent and subsidiary and therefore that payment had occurred.

Statement

Defendants-petitioners rely on the statement of the Loan Transaction of the United States District Court, Southern District of New York, as set out in plaintiff's petition Appendix B at 36a-38a.

Reason For Granting
The Writ

Set out herein is a brief in opposition to plaintiff's petition for a writ of certiorari, setting forth the reasons why that issue does not warrant review by this Court. While the question posed in this cross-petition does not call for independent review by the Court, it nevertheless should be reviewed if, but only if, the Court grants the petition in

No.   , this Term. Substantial justice requires that the two transactions, litigated together for sixteen years and inextricably tied by the facts, including Buchman's conspiracy, be ruled on together by this Court, if it is to rule on one of them.

Conclusion

For the foregoing reason, it is respectfully submitted that, if the Court grants the petition for writ of certiorari in No.   , this Term, then in the interest of justice, it should also grant this conditional cross-petition for a writ of certiorari.

Respectfully submitted,

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Respondents
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